The BANKING LAW JOURNAL

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Financing of Imports

A. van BIEMA

After the end of World War II under the slogan "Trade instead of Aid" the United States started to do everything in its power to enable foreign countries to gain or regain its fair share of the American import market. Under the Marshall Plan foreign factories were rebuilt and re-equipped, often with the most modern American machinery. Under "Point IV" and other similar programs, foreign countries producing raw materials and finished products were given help and advice how to increase their production and how to better adapt their finished goods to the demands of the U.S. market. The success of these efforts has been great, particularly in Western Europe and Japan. Much still remains to be done regarding those countries whose economies depend to an overwhelming degree on the sale of raw materials.

However, in spite of the fact that our country deliberately set out to help foreign countries in re-establishing their share in the American market, it now appears that some people feel we have succeeded too well. Did these people wish that our recovery program should not be successful? Would they prefer if our efforts to re-establish healthy economic conditions abroad had been a failure? Are they not aware of the fact that even today our commercial exports are running well ahead of imports? Are they not aware that our much discussed balance of payment deficit is of a political and military nature and NOT of commercial origin?

Mr. van Biema is Executive Vice President and Director of Amsterdam Overseas Corporation, 70 Pine Street, New York City. He is also a Director of the National Commercial Finance Conference, Inc. and Chairman of its Educational Committee. The author gratefully acknowledges the legal research assistance of Seth E. Frank, Esq. of the New York Bar. Mr. Frank is associated with the firm of Abraham L. Bienstock.

Imports to the United States are currently running on an annual rate of slightly less than 16 billion dollars. In an economy like ours where the gross National Product approaches the 500 billion dollar mark, this figure is by no means out of line. About half of it covers essential raw materials without which our economy could not function, such as tin, nickel and newsprint, ferro-alloying ores and metals, industrial diamonds, mica and asbestos. One-fourth of our iron and one-third of our copper and rubber comes from abroad and we would all have to go without the many cups of coffee that we consume were it not for imports.

In addition, there can, of course, be no question that imported manufactured products have found a degree of acceptance on the American market, which would have been considered unbelievable a few years ago. One look at our highways crowded with foreign cars in unprecedented numbers will prove the point. Foreign foodstuffs are on every grocery shelf. Certain domestic industries have felt the impact of foreign products much harder than most others, just to mention textiles, carpets, pocket size radios, stainless steel flatware and plywood. In some cases, American owned factories abroad ship back to the United States products for which the American parent companies have established a ready market years ago and which they can now make cheaper in foreign countries.

The tremendous increase in air transportation has been another factor to facilitate imports. Perishable products can arrive on the American market within a day from the date of shipment. No longer need the merchant fear a great time lag between the time he places the order and the time he receives the goods—if the merchandise warrants the higher rate for air freight, he can have it within a few days.

This factor and the completion of the St. Lawrence Seaway together with the constant increase in our domestic price level will continue to make a much larger segment of the whole country import-conscious. Prior to the Second World War it is safe to say that the bulk of foreign trade was concentrated on the Eastern Seaboard with the balance limited to a small number of port cities such as New Orleans and San Francisco and

a few others. It is not surprising, then, that expert knowledge of foreign trade financing was concentrated with the banks in these foreign trade centers with the addition of a few large banks in Chicago and some other important metropolitan cities. As the volume of import business tends to increase and more and more merchants in traditionally "inland" centers become import conscious, it might be better for those banks which have not heretofore given much thought to the question of import financing, to familiarize themselves with some of the basic questions involved. This is all the more true as the import business is not dominated by a few giant concerns but is handled by a great number of firms of different size and capitalization, so that each bank can find among the many importers those whose volume of business is just of the right size.

Traditionally, the most frequent method of import financing through a bank has been by way of the bank establishing a Letter of Credit in favor of a foreign shipper, which Letter of Credit may either be sent directly by the American bank to the foreign beneficiary or be notified (and in some cases even confirmed) by the American bank's correspondent bank in the foreign country where the beneficiary has his place of business.

PURPOSES OF LETTER OF CREDIT

The purposes served by the commercial Letter of Credit have been well articulated by the Courts. In *Kingdom of Sweden v. New York Trust Co.*, 197 Misc. 431, 441-42 (Sup. Ct. 1949) the Court stated as follows:

> "The purpose of financing a sale where a prospective buyer in one locality desires to purchase goods of a prospective seller in another locality gives rise to the need for a ready means of transmitting the purchase price. To compel a buyer to send cash with his order or to pay cash against shipping documents would necessarily place an almost impossible burden upon his capital. The seller, on the other hand, will often refuse to accept the buyer's note, for in a place where the maker is not known, such paper is not readily marketable. When the draft of a bank is given, the seller has commercial paper of greater marketability. The buyer nevertheless still has to pay the bank cash for its draft or has to give adequate security before it will be issued.

> Moreover, from the buyer's point of view, there is a further disadvantage in that, in order to turn over the notes or drafts against shipping documents, he must forward these negotiable instruments to the seller or his agent. The business problem, therefore, is how to meet the desires of both the buyer and seller to enable them to consummate their transaction in the most convenient manner. How can the seller receive his money upon shipment of the goods? How can the buyer postpone actual payment until the goods have been received and sold? How may a bank lend its credit without actually using its funds? How may the goods be utilized as security until actual payment is made therefor? The instrumentality of the commercial Letter of Credit enables all of the parties concerned to answer these questions and to meet and fulfill all of these requirements . . . ."

The essence of a Letter of Credit is the bank's expression of its willingness, for account of the buyer, to permit the seller to draw on certain terms and that all such bills shall be honored. See Ward and Harfield, "Bank Credits and Acceptances in International and Domestic Trade" p. 8 (3d ed. 1948). Thus, the courts have stated that while ". . . a Letter of Credit need not be in any particular form of phrasing . . . there must be some writing directed to the beneficiary and delivered to him by the issuing bank, or pursuant to its authorization, which purports to bind the issuing bank to be responsible for drafts drawn under the Letter of Credit." *Bril v. Suomen Pankki Finlands Bank*, 199 Misc. 11, 19 (Sup. Ct. 1950). In the *Bril* case there was no delivery of such a writing to the beneficiary, and as a result the bank was held to have incurred no obligation to the plaintiff.

BASIC CONSIDERATIONS FOR IMPORT FINANCING

I think that a bank which is approached with a request to finance the import of some foreign merchandise should ask itself whether it would be interested in handling the financing provided the goods in question came from some spot within the United States. If the answer to that question is "Yes," then the bank should look into the proposed import financing. Of course, at least the same safeguards as to moral responsibility

and financial standing of the customer that would be demanded in case of domestic financing, should be applied in the financing of imports. Unless the financial statement of the customer is such that he is entitled to unsecured credit, no higher—and possibly even a lower percentage of advance should be considered, than the one that would appear safe for a comparable domestic transaction.

When a bank opens a Letter of Credit for merchandise to be imported to the United States, it is, in effect, extending credit against merchandise *not yet in inventory*. Therefore, all the precautions which usually are used in extending credit against merchandise already in the inventory of the client, must be observed—and then some. A bank would normally not think of advancing 100% of cost of goods—so it should not think of opening a Letter of Credit without at least as much of a margin (either in form of cash or in form of other collateral) as would be required for financing of domestic inventory. Only in the rarest case, would an advance be made against inventory not inspected by an independent expert—and it follows that the greatest care should be taken to make sure that the inventory to be financed by way of Letter of Credit which neither the customer nor the bank has as yet seen, will be of the quality that it should be. In addition there are a number of special points which should be taken into consideration in considering a request for import financing and I shall try to mention the most important ones:

Customs Duty

In thinking of imports, most everybody is aware of the fact that imports require the payment of a customs duty. Only a few categories of goods, such as raw materials, are exempt from customs duty, and for many goods the customs duty is very high, often 30% or 50% or even 75% ad valorem. One must, therefore, bear in mind that upon arrival of the goods somebody will have to have the money to pay for the customs duty. A bank might think that it extends a credit of $100,000.00 if it opens a Letter of Credit for such an amount, but actually it might find itself forced to advance another $50,000.00 for duty

when the goods get here. It can readily be seen why this problem should be clarified in advance. This, however, is more involved than it sounds. The customs duty is not something which one can simply look up in a book. There is, of course, a rather voluminous book which can be bought at the Customs House, and which contains the customs tariff, but I strongly recommend not to buy it and not to look at it because, unless you are an expert, it will confuse you rather than enlighten you. Customs duties are fixed by Act of Congress but the Executive Branch has substantial leeway to change the effective rates through trade agreements and by invoking the right to increase rates if it finds that domestic industry is imperiled by imports, as we have seen some time ago in the case of Swiss watches and foreign bicycles. Also the classification of goods and their valuation for customs purposes and thereby the applicable rate of customs duty is subject to the individual interpretation of the tariff by the Customs Appraiser in each port of entry. One can, of course, appeal the decision of the Appraiser to higher authorities but this is a tedious and long-drawn out procedure. Furthermore, one cannot always follow previous experience, because customs duty often differs even if the basic classification of the merchandise is the same. A bank might have financed previously the import of French buttons costing $5.00 a gross and the duty might have been 25%, but if the customer now wants to bring in French buttons costing $6.00 a gross, the duty might well be 50%, or the $5.00 buttons might now be of Belgian instead of French origin and that again might change the rate of duty. Therefore, I recommend whenever imported merchandise is being financed and there is any doubt whether the customer, who is the importer, knows exactly what the duty will be, to consult with a reliable customs broker and let him verify the customer's statements.

One particularly important thing to keep in mind is that even after goods have been cleared through the customs and the duty thereon has been paid at a certain rate, the government can come at a later date, maybe years after the date of clearance, and reopen the whole entry and assess the importer for additional duty. For this reason a bank must never, never make

any customs entry in its own name. The customs entry must be made in the name of the importer through an established customs broker, and any arrangements which the bank might want to make in order not to let the control of the goods get out of its hands must be made with the customer and the customs broker who will usually be willing to act as a trustee for the bank. Under no circumstances must the bank make the entry in its own name because years afterwards unpleasant surprises might result.

This leads me to another point which is of equal importance:

Payment of the Duty

Quite frequently people will ask for financing of imported goods on which the duty has not yet been paid, that is to say, goods which are held in bond. The customer will then produce a warehouse receipt purporting to show that he has title to the goods and that he can give a good lien. Care must be exercised before making such a loan. As long as the duty on these goods has not been paid, and as long as these goods are held in bond, the United States Customs will not recognize title as evidenced by the warehouse receipt, and the holder of the warehouse receipt cannot go to the customs authorities and pay the duty himself and take the goods out. The payment of the duty must be made by the same party who originally made the so-called in-bond entry and without the cooperation of this party nobody can pay the duty. Usually, of course, the customer will have made the in-bond entry and he will cooperate regarding customs clearance, but if a bank wants to make sure that at any time in its own discretion it can pay the duty on the goods and take them out of the bonded warehouse and sell them in this country, then it must insist that, together with the warehouse receipt, it gets an authorization on Customs Form No. 7505. This is the only form that the customs will recognize after it has been filed and accepted by them and it has to be signed by the party who made the original in-bond entry. Only this form will make the bank the owner of the goods as far as the customs authorities are concerned. Consultation with a customs broker is recommended concerning the filing of this form,

because it has to be done just right in order to achieve only the desired result. Our company had a case a few years ago where a customer was in default and we had some merchandise in bond as collateral. In-bond entry had been made in the name of the customs broker, and this customs broker simply refused to pay, for our account, the duty on the goods which were our collateral unless we would pay him first all the money that was due him from the defunct customer covering services over a period of more than a year. I talked to the Director of Customs in Washington, D.C. and was told politely but firmly that in the absence of Form 7505 the customs authorities would not recognize anybody to pay the duty other than the party who made the original in-bond entry. We had to make a settlement with the customs broker through our lawyers before we could lay our hands on the goods which were pledged to us.

In this connection, a word might be said about the "Free Zone." Such Free Zones exist in a few major U.S. ports—New York, San Francisco, New Orleans, Seattle and San Antonio. They represent a certain section of warehouses in the port which, as far as the customs authorities are concerned, is considered to be outside of the United States. Merchandise in the Free Zone is just as suitable as collateral as merchandise in bond. The main difference between the two is that merchandise placed in the Foreign Trade Zone—or Free Zone as it usually called—is not considered as having entered the commerce of the United States whereas merchandise placed in bond is considered as having been imported into the United States with the payment of the duty temporarily postponed.

If I have the choice between advancing money against merchandise in bond and merchandise in the Free Zone, I would prefer the Free Zone because it is easier to inspect or repack them and the goods can even be manipulated or processed in the Free Zone, which is impossible in bond.

Four Government Departments

So much about customs. Another barrier which obstructs the entry of certain imported merchandise is less widely known than the customs requirements. Four Departments of the

United States Government have some say regarding the import of certain goods.

The U.S. Treasury, Foreign Assets Control deals with imports from certain iron curtain countries, and particularly from Red China and North Korea. My advice at this time is to stay away from any such products because the technical difficulties in getting clearance are usually too great to make the financing worth while. Also it is recommended to watch out for goods which traditionally come from China, such as hog bristles, but which a customer might want to import from some other country, say Japan or South Korea. If the Foreign Assets Control has any suspicions that the origin of these goods might be Red China, the importer will find himself in a great deal of difficulty and the financier will wish that he had not financed the goods.

The U.S. Treasury further controls the compliance with certain quota regulations for imports which includes about 50 commodities such as for instance sugar, tobacco, woolen fabrics, stainless steel, etc. It also protects the owners of registered trademarks against import of trademarked goods by unauthorized sources—so it is best to check with a customs broker about a request to finance a shipment of Chanel No. 5 or Leica cameras. Also, of course, Wines and Spirits cannot be imported by anyone who does not have a license to do so.

The U.S. Treasury also controls the import of narcotics and gold, but I don't think these products are likely to be offered for financing.

The U.S. State Department controls the import of firearms and ammunitions. This is something which is not too difficult to handle and we have, for instance, financed the import of shot-guns and hunting rifles for which the appropriate licenses were obtained from the State Department without any difficulties.

The Department of Health, Education and Welfare administrates the Food and Drug and Cosmetics Act with which most of the readers will be somewhat familiar. No food products, drugs or cosmetics can be imported into this country without being cleared by the Food and Drug Department. In many cases the foreign customer will not expect to get paid until such

clearance has been effected and, therefore, the bank will not have to worry about it, but if it should be required to open for a customer Letters of Credit for the import of goods subject to the Food and Drug Act, but payable before passing of Food and Drug inspection, the bank might want to insist that the customer takes out an insurance against rejection by the Food and Drug authorities. Such insurance is usually obtainable at reasonable rates if the foreign shipper is a reputable source of supply.

The Department of Agriculture through the Bureau of Animal Industry—B.A.I. for short, controls the import of animals and plants and the inspection of meat and hides, and the setup is similar to the Food and Drug Department. In connection with all these questions of customs duty and import control, I cannot recommend strongly enough that any bank which wants to engage in the financing of imports should establish a good working relationship with a reputable and competent customs broker. Whilst I do not believe in breaking up existing relationships between importers and their own customs brokers, it has been my experience that it is very helpful for you to have a customs broker to whom you can channel as much as possible of the business that comes to your attention, and who in turn will provide you with up-to-date advice on questions of customs duty and other important requirements.

Back-to-Back Letter of Credit Financing

In imported goods, just as in domestic goods, it is, as a rule, preferable to finance merchandise that has been sold rather than merchandise which the customer hopes to sell at a later date.

By far the best and safest import financing of sold goods is the so-called back-to-back Letter of Credit financing where the client, the importer, has sold the goods to his customer f.o.b. foreign port against a letter of domestic credit and the bank, in turn, opens for its client a back-to-back Letter of Credit in favor of the foreign shipper. Even in this ideal case it is well to remember that practices as to acceptance of foreign documents vary from bank to bank and it has happened more than once that

one bank has paid out money on one set of documents under a Letter of Credit and another bank has refused to pay out money against the same documents. Furthermore, the bank should take the one precaution of procuring from its client, who is the beneficiary of the domestic Letter of Credit, his own invoice at his contract price. This is necessary since the bank must be able to present the invoice of the proper seller to the buyer. See *Kingdom of Sweden v. New York Trust Co.*, 197 Misc. 431, 442-43 (Sup. Ct. 1949) and authorities there cited.

More frequent, however, will be cases where the importer has sold the goods, duty paid, C.I.F. American port of entry and requests the opening of a Letter of Credit in favor of his foreign supplier. In this case, it will usually be a good idea to look into his sales contracts between the importer and his customers. One must bear in mind that imported manufactured goods usually do not have the same broad market as goods of standard American manufacturers. In financing standard American merchandise, one usually knows pretty well that if one should get stuck with the merchandise, there is most likely a way to get rid of it at more or less substantial discount from the manufacturer's price. This will not necessarily be true with many imported manufactured goods for which there might only be a small number of American distributors who, in turn, might prefer to handle or even contractually be obligated to handle products from their own regular foreign sources of supply rather than to pick up a distressed lot of foreign merchandise that somebody else has imported. Therefore, when looking at the orders which the customer submits, it is recommended to satisfy oneself that they are firm orders. If possible, one should try to finance only goods which this particular importer has sold for some length of time to the same kind of customers. Also it is an added safety feature to finance the import of goods from a country which is traditionally famous in this particular field of merchandise. I need only to mention leather goods from England, optical instruments or toys from Germany or watches from Switzerland to illustrate this point. Special caution is indicated where goods come from a country which has no previous experience in selling such goods in the United States and

which might not be familiar with the requirements of styling suitable for the American market. I would always go rather slow on goods which the importer is bringing in for the first time and I would certainly require a larger margin in such a case. A good way to check the sales potential of new items is consultation with a buyer from a large department store or buying office. These people are usually interested in seeing anything new that is on the market and we have had several occasions where we could get valuable information from such sources. Of course, for checking the reliability of the foreign shipper there are a number of sources available, such as the American Commercial Attache in the country in question or the Chamber of Commerce which the foreign country might maintain in the U.S.A. or foreign consulates or embassies.

An Irrevocable Domestic Letter of Credit

The best evidence of a firm domestic order is, of course, an irrevocable domestic Letter of Credit, even if it is not back-to-back as previously discussed but instead covers the imported goods after they have arrived in this country, after duty has been paid and possibly after re-packing or other manipulations. Such Letter of Credit—just as most any written order will stipulate the latest date of delivery for the foreign goods and in opening a matching foreign Letter of Credit one must allow sufficient time for the goods to get here. Therefore, in stipulating the latest date for the Bill of Lading from the foreign port, one should check with the shipping lines involved how long their boats usually take to get here. Often it might be well to ask the customer on which line he expects the goods to be shipped, and to stipulate the shipping line, or even the boat, in the foreign Letter of Credit. One risk which is frequently overlooked in this connection is that of deviation. You might have considered yourself safe in your timing by allowing four weeks or even six weeks for the goods to come here from a European port before the latest date at which the customer has to deliver the goods to his buyer but what happens if the ship carrying the goods suffers a minor breakdown on the high seas and has to pull into the nearest port for repairs? It might be a couple of

weeks before the repairs are made and unless the goods are damaged, the customer cannot recover under Marine or War Risk Insurance. However, if he has deviation insurance, this will cover him for the damage caused by the fact that the ship did not proceed directly to the port of destination. The bank will do well to keep deviation insurance in mind particularly in dealing with substantial amounts and with seasonal merchandise. Christmas tree ornaments arriving here after December 24 are not a desirable object for financing.

One risk that is always present in import financing unless on a back-to-back Letter of Credit basis is the risk of strikes at the port of arrival. Longshoremen might not unload the ship when it arrives or truckmen might not move the goods from the dock or from the customs warehouse. Insurance against such risks can usually be bought but most importers will shy away from this additional cost and as a rule a bank will have to be satisfied to take its chances in this respect. Of course, everybody will be especially on guard if labor unrest in the harbor seems to be brewing or if a strike should actually be in progress when import financing is requested.

IMPORTANT POINTS OF IMPORT LETTER OF CREDIT

How great is the ignorance prevailing about the nature of a Letter of Credit! Here is a story which I got from one of our banking friends—and it is a true story, even though it sounds rather unlikely.

A Foreign bank's Letter of Credit (notified and confirmed by an American bank) was issued in favor of a domestic beneficiary in an assignable form covering shipment of crude oil to a European port. The domestic beneficiary then assigned the Letter of Credit to a Midwest prime supplier of crude oil. The Midwest assignee knew that the crude oil was not available for shipment and shipment would not be effected but at the same time he was in need of some structural steel for his own purposes. The assignee exhibited the assigned credit to a steel mill who was completely unfamiliar with Letters of Credit. The steel mill delivered the structural steel to the assignee on the basis that

the assignee endorse the credit to the steel mill by writing "Proceeds of this credit ——— to be paid to ——— Steel Mill."

An official of the steel mill arrived at the office of the New York bank that advised the Letter of Credit requesting the face amount of the credit. After informing him that the credit was only payable against presentation of the original ocean shipping documents mentioned in the credit, he then explained how he had been talked into supplying a quantity of steel on the assumption that he could come into the advising bank and request payment after the assignee assigned the proceeds to him. I hope and trust that none of your customers would have fallen for such a brazen fraud, but I think it is an interesting illustration about the general ignorance prevailing about Letters of Credit.

Many a customer while not as naive as the one described above does not know exactly how to make out a correct Lettter of Credit application and you should therefore sit down with him and go over every item on your application blank to make sure that you know exactly what he wants. Never, never fill in any blanks which the customer has left open without checking with him and getting his approval in writing. Your customer will be looking to you for guidance and advice. If you do not have much actual experience with the issuance of a Letter of Credit, you will be far better off in consulting *beforehand* with the Letter of Credit department of one of you metropolitan correspondents, than to issue a Letter of Credit which does not in every way serve the best interests of your customer. By all means make clear to your customer that a Letter of Credit deals in documents, not in goods. If the documents are all right the opening bank will have to pay even if it is told that there are stones in the bags instead of the goods the customer has ordered. A typical court decision on this case can be found under "*Kingdom of Sweden v. New York Trust Co.*, 197 Misc. 431, 444 (Sup. Ct. 1949)."

> "In the absence of a provision in the primary Letter of Credit, the defendant New York Trust Co. was not obliged to and could not properly have been permitted to go behind the documents in order to examine the quantity, quality, or any other feature of the merchandise purchased by the plaintiff, unless such documents

were not genuine on their face or did not conform with the requirements of the Letter of Credit (citing cases)."

Thus, in *Laudisi v. American Exchange National Bank*, 239 N.Y.234, 243 (1924), the bank was protected on its payment because the defect was in the goods and not in the documents, the court stating the distinction as follows:

"The contract between the customer and the bank under which the latter issues an Irrevocable Letter of Credit is entirely distinct and apart from the contract between such customer and, as in this case, his vendor under which goods are to be shipped. The question between the customer and the vendor is the one whether the goods comply with the contract and if they do not the former has his appropriate right of action. The question between the customer and the bank which issues the Letter of Credit is whether the documents presented with the draft fulfill the specific requirements and if they do, speaking of such facts as exist in this case, the bank has the right to pay the draft no matter what may be the defect in the goods which have been shipped. The bank is not obliged to assume the burdens of a controversy between the vendor and vendee and incur the responsibility of establishing as an excuse for not paying a draft that the vendee's version is the correct one."

Conversely, since the risk of defective goods is a risk of the customer and not of the bank, the bank cannot refuse to pay on the ground that no evidence was presented to it that the goods in fact conformed to their description in the documents. *O'Mear Co. v. National Park Bank*, 239 N.Y. 386 (1925). But where the Letter of Credit guaranteed payment for "dried grapes" and the Bill of Lading was for "raisins," the bank was excused for refusing payment since the variance was in the documents and the bank was not required to decide whether the quoted terms were identical or not. *Bank of Italy v. Merchants National Bank*, 236 N.Y.106 (1923). Accord: *Lamborn v. Lake Shore Banking & Trust Co.*, 231 N.Y. 616 (1921) (Letter of Credit specified "Java White granulated sugar"; shipping documents referred to "Java White sugar").

Any bank will, of course, try to avoid any dispute with its customer, even if the bank will come out on top in the course. Therefore, unless the customer is absolutely sure of the charac-

ter and integrity of his foreign shipper, it is imperative to ask for a Certificate of Quality or Certificate of Inspection by an independent agency. Just to mention two such agencies, the Superintendent's Company maintains offices in most parts of the world and usually the Lloyd's Insurance Agency in the particular foreign port will also serve as a good source for this kind of certificate.

Of course, the best inspection certificate will not do you any good unless the description of the merchandise has been specified in the first place. Therefore, the foreign Letter of Credit should not say "steel," when the product to be imported is "steel bars," so many inches thick and so many inches long; it should not say "glassware," when the customer ordered "8-ounce tumblers" or "1-ounce short glasses"; it should not say "leather goods," when the customer wants to import "wallets," or "belts," "briefcases" or "luggage." Be sure to be specific as to price and unit for which the price applies. Friends of ours once opened a Letter of Credit for bananas which stipulated so and so many cents per bunch. The customer had failed to stipulate the minimum weight per bunch and I believe that the bananas imported under this Letter of Credit were the smallest bananas ever to reach the Continental United States. There was nothing the customer could do; the price was stipulated per bunch and the bunches were all there, however small. If the inclusion of too much detail regarding price, specifications and quality of the merchandise might make the Letter of Credit too unwieldy, one can permit the Letter of Credit to be fairly brief regarding these items, provided that the Agency which will issue the Inspection Certificate is fully informed, just exactly what the customer expects to get. In this way one can make sure that if the Inspection Certificate accompanies the foreign documents, a neutral source has satisfied itself that the goods are of the proper quality, quantity and specifications.

The Courts have held that the duty of adequate description is on the parties who undertake the Letter of Credit and not on the Courts which merely construe the contract, are powerless to make a new one, and are unwilling to disturb established commercial practices. In *Laudisi v. American Exchange National*

Bank, 239 N.Y. 234, 242 (1924), the Court stated as follows:

> "The whole process of authorizing banks to issue Letters of Credit under which the purchase price of goods is often paid for account of the vendee before he has had a chance to examine them is largely based on confidence in the honesty of the vendor. If the vendee is suspicious of dishonesty he can guard against it by appropriate clauses in his contract. But certainly the courts ought to exercise no power of embarrassing or confusing widespread processes of commercial life by inserting in such contracts as this one, clauses which it may deem in a particular case might have been quite properly placed there but which as a matter of fact the parties were content to disregard and omit. The customer can impose and it will be the duty of the Courts fairly to enforce all the restrictions and safeguards he desires. But they should not by strained interpretation impose those which he has omitted."

It might also be important to specify *where* the inspection is to take place, because an unscrupulous foreign shipper might have perfect goods inspected in his warehouse, but might later on not ship the same merchandise that has been inspected. Inspection right at the pier, just prior to loading on board of the steamer is, of course, usually the best, whenever it is physically possible, otherwise it might be arranged that the inspection company supervises the shipment from the point of inspection to the pier. The minimum safety requirement is that all bales, boxes or other containers are properly identified by marks and numbers and that the Inspection Certificate ties into the same marks and numbers.

The bank's payment of a draft without the Inspection Certificate required by the Letter of Credit was fatal to its recovery over against its customer; nor was the defect cured by the bank's subsequent receipt and retender of the Inspection Certificate unaccompanied by the other documents. *Anglo-South American Trust Co. v. Uhe*, 261 N.Y. 150, 157 (1933). Thus, in order to comply with the terms of a Letter of Credit, which are always strictly enforced by the courts, the bank should insure (1) that it has all of the required documents before paying the draft; and (2) that it tenders all of the required documents at one time to its customer. The *Uhe* case is fair warning against attempting a piece-meal method of compliance.

The next important thing to consider in the opening of a Letter of Credit is the question of insurance against Marine and War Risks. In dealing with a reputable importer, a bank, as a rule, will be prepared to take his word for it if he puts on his application "insurance covered by buyer," i.e., by the importer. The bank, however, might want to make sure that the importer's policy is in full force and effect and might want to require that a rider be added into the policy showing the bank's name as beneficiary "as interest may appear." In other cases, the customer will require that the foreign shipper insures the goods and that the Insurance Certificate be attached to the various documents which the Letter of Credit requires. This will require some special care. The goods might come from a country under foreign exchange restrictions or where uncertain political conditions prevail. The foreign shipper might, in perfectly good faith, take out an insurance policy in his country but the American bank would probably not like the idea to negotiate about a loss with an insurance company domiciled in a far-away and politically unstable country. Therefore, in allowing the foreign shipper to take care of the insurance, one will be well advised to stipulate that the insurance must be in U.S. dollars and must be with a first-class American insurance company or with Lloyd's of London. It is customary to stipulate that goods be insured with at least 110% of the invoice value to cover expenses which are incidental to a loss and some compensation for loss of profit. If you finance for your customer all or part of the duty, you might want to insist that he takes out duty insurance, which will refund to him the damage he might suffer for paying duty on goods which are damaged or stolen before they reach the ultimate consignee.

In your Letter of Credit you will have to state whether the drafts must be negotiated or presented not later than a certain date. If you stipulate a negotiation date, this means that the only deadline that you are putting on the validity of your Letter of Credit is the date at which the foreign shipper goes to his local bank in the foreign country and negotiates his documents there. It is by far more advantageous to stipulate an ultimate presentation date, i.e., the date at which the documents have to be

presented to the American bank for payment. This way you can be sure that the documents will be in this country before you have to pay out any money and that the American bank alone will be the final judge whether the documents are all right. You will also be able to protect your customer against presentation of stale documents, i.e., documents present too long after the boat has left.

In the recent case of *North Woods Paper Mills, Ltd. v. National City Bank,* 121 N.Y.S. (2d) 543 (Sup. Ct. 1953), the plaintiff was the beneficiary of a Letter of Credit opened by a Portuguese bank and confirmed by the defendant, a New York bank. The Letter of Credit specified a date certain for expiration and incorporated by reference a term of the Uniform Customs and Practice for Commercial Documentary Credits permitting the bank to refuse documents presented to it "with undue delay." Pursuant to the letter, defendant honored two drafts of the plaintiff for two shipments of goods. Thereafter, while the second shipment was on the high seas, but prior to the expiration date in the Letter of Credit, plaintiff claimed an additional sum allegedly due to its own erroneous discount from the price of the second shipment. Payment was refused. The Court gave judgment for the defendant on the ground that the provision of the Uniform Customs and Practice referred to above gave the bank "the absolute right" to reject plaintiff's tender of amended documents made sometime after the goods were on the high seas and after payment had been made on the original documents. The Court ruled that the defendant had the right to consider the transaction closed and was not bound to reopen it.

In the absence of a specified expiration date, presentation for payment may be made "within a reasonable time," and when so made, must be honored. *Lamborn v. National Park Bank,* 240 N.Y. 520, 532 (1925).

Sometimes a customer will ask for financing of foreign merchandise which is already afloat. He will show you a Bill of Lading or evidence of title and offer this Bill of Lading to you as collateral. Of course, a Bill of Lading is a negotiable instrument and if made out to the man's order or endorsed to him, this

looks all right. Usually, however, Bills of Lading are issued in two or three originals, and I should like to stress emphatically that each original will get possession of the goods as far as the shipping line is concerned. Therefore, unless you have a full set of Bills of Lading, i.e., as many originals as have been issued (you can see that typed or printed right on the Bill of Lading), you have no proof whatsoever that you will get the goods when they arrive. If you have only one of two or three originals, somebody else might have another one and might grab the goods when they get here. Therefore, please remember always to insist on a full set of Bills of Lading before you pay out any money unless you want to run the risk of meeting another bank or finance company at the dock trying to get hold of the same goods.

CONTROLS AFTER ARRIVAL OF GOODS

The American bank's supervision and control over the goods should, of course, not end after the goods have arrived in this country, unless the customer pays in full at that point. Frequently, the customer will require release of the goods in trust for the purpose of clearing same through the customs. If you grant this request, make sure that the goods are returned to your custody (by way of warehouse receipts or field warehouse receipts) as soon as customs clearance has been effected. Actually it is not necessary for the bank to release goods in trust for customs clearance purposes, as the bank can just as well hand over the documents to a reputable customs broker for the purpose of clearing same through customs in the name and for the account of the customers, but with the understanding that title in the goods remains vested in the bank and that after customs clearance the customs broker will deliver the goods in the name of the bank to a designated warehouse or field warehouse. Even if the bank does not finance the accounts receivable resulting from the ultimate domestic sale of the goods, it is good policy for the bank to satisfy itself from time to time that the customers do sell the imported goods in the regular course of business and on a profitable basis. A good story to indicate the importance of such "follow up" as well as the importance of Inspection

Certificates mentioned above can be told here with the permission of one of our banking friends who was a party thereto:

For years one of their customers had imported a certain European product from one source. For years, the bank's customer had received the goods from the bank on Trust Receipt and paid the bank within 90 days. The bank had never bothered to check about the sales of the goods by their client in the domestic market, and if once they had insisted on Inspection Certificates, this had been discontinued long ago—after all—was not the experience most satisfactory! Unbeknown to the bank, the customer had gotten into financial difficulties and so he decided to take the bank for a ride. He got together with a party in the foreign country in question, who agreed to act as his dummy. Then he caused the bank to open a Letter of Credit in favor of the Dummy for the same goods which he had formerly bought from the respectable European source. The dummy shipped the proper number of containers, but, of course, they did not contain the right kind of goods but worthless rejects. The goods arrived and were released on Trust Receipt. Promptly, our client shipped them back to the dummy. Well, before the customary 90 days were up, the client caused the bank to open another Letter of Credit in favor of the dummy and there came the goods for the second time. Having received money twice from the bank through the dummy, our friend could now very well afford to pay our bank for its first trust receipt right at maturity. This game went on and on until the hole our friend was in became too big to be filled even by this ingenious method—and the bank learned of his troubles from another source. Looking then for its collateral, it found, of course, that there was none. A quality certificate at the shipping point or a checking of the customers sales and insisting on getting paid for the merchandise released on trust by original check from the ultimate buyers of the imported goods would have prevented the loss.

Some laxity prevails on the part of some banks with regards to release of goods against trust receipt. Sometimes in such cases the bank will not worry about the fate of goods until the expiration of the trust receipt—often 90 days. Meanwhile, the

customer may have sold the goods and received payment for same, thus destroying the bank's lien, or he may even have borrowed money from another bank or finance company either against a warehouse receipt or field warehouse receipt representing the goods or against the Accounts Receivable resulting from the sale of the goods. If a bank extends Trust Receipt privileges it is always good policy to check from time to time that the customer makes only proper use of this facility. Needless to say that it is imperative to comply with the laws of your State governing Trust Receipt financing in order to establish a valid lien in the first place.

Little—if anything at all—in these lines will be new to the reader who has had some experience of his own in the field of import financing. For those whose experience in this field has been limited or who may as yet not have had an opportunity to be confronted with these questions, I hope these lines contain some helpful hints. Financing in any field is no job for amateurs. Import financing is no exception. But import financing is in no way more complicated or more risky than any other form of financing. Any bank will be well advised to have on its staff at least one man with enough expert knowledge in these matters to know where he can safely act on his own and where he might need the advice and assistance of a more experienced bank. If the volume of imports continues to grow as it has in recent years, such a man might within a few years time become the nucleus for an important and profitable "foreign department" within his institution.

Automation, Forged Checks and The N. I. L.

KENNETH M. JOHNSON*

In a recent law review article there appeared a statement which so well expressed the relationship of legislation to commercial practice that it is here quoted:

> "A corollary to the desirability of codified commercial laws should be the continued adherence to an underlying principle of commercial law—that the rule exists to foster the usage to which it relates. As a commercial usage changes, effort should be exerted to bridge the gap between the codified rule and the changed usage."[1]

In so far as bank checks are concerned the most important recent development is that of automation through the use of electronic accounting in various forms. In the very near future it may be anticipated that each depositor maintaining a commercial bank account will be given a number which will be imprinted on all of the depositor's checks in magnetic ink and which will be susceptible to being read by an automatic scanning device.[2] At the first point where such coded check reaches a bank (or at least the drawee bank), in the normal course of listing, the amount will also be imprinted thereon in similar magnetic ink. At the drawee bank the check will be placed in apparatus which, on the basis of the magnetic account number and printed amount, will charge it against a memory device holding the former balance of the account in question. Deposits will also be handled in the same manner. An adjunct of the same equipment will automatically prepare the depositor's

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[1] Washington University Law Quarterly, 1958, Vol. 4, Page 445.

[2] Although magnetic ink is referred to in this article this may not be the final method; systems are being considered which will utilize isometric or isotopic inks. What is required and what has been accomplished with magnetic ink is to have Arabic numbers with such qualities that they are subject to both visual and automatic reading.

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statement at any time that it may be desired. The important fact is that the entire operation is triggered by the account number appearing on the check and that the operation is entirely automatic.

In practice the bank will rely on the magnetic number. The signature will diminish in importance. Actually the signature, for some time past has had more importance in legal theory than in bank practice. For many years it has been a fiction that the quick examinations by bank tellers or bookkeepers of signatures on checks have all the characteristics of analysis by a handwriting expert for the purpose of determining whether or not the signature is a genuine signature of the depositor. A large unit bank may have between 75,000 and 100,000 commercial accounts. Experience indicates that on an average there will be between 1.6 to 2 checks per day per account. This means that in one day there may be up to 200,000 items presented to that bank for payment. Under the rules of most jurisdictions the item must be either paid or returned by the close of the business day following the presentation.

Every year the volume of checks becomes greater. Unless service charges to the depositor are increased to a prohibitive level it is impossible with this volume to make an expert handwriting analysis on each check. This has been true for some time in the past and will obviously continue to a larger extent in the future when payment occurs as a result of an electronic reading of a number as well as by a visual examination of the instrument. In view of this there are certain areas in the existing law of checks which should be reviewed and considered.

At the outset it should be observed that in so far as their nature is concerned coded checks would fall somewhere between ordinary checks and checks bearing a facsimile signature. Certainly both coded checks and checks bearing a facsimile signature have latent possibilities of being dangerous instrumentalities. Possibly the question narrows down to, at whom is the gun pointed? Although upon first consideration it may seem startling, there appears to be one set of facts where the bank should be permitted to charge the depositor's account

with a coded check even though the depositor's signature is a forgery. The five essential factors to this result would be as follows.

(a) Coded checks are being used.

(b) The checks are stolen or lost and the depositor is aware of this.

(c) The depositor does not notify the bank of the loss or theft.

(d) The bank pays one of the stolen checks in the ordinary course of business and without knowledge that the check has been lost or stolen.

(e) The forgery resembles the genuine signature.

When the depositor knows that the operation of payment is activated by the magnetic number in addition to what must in practice be a very hasty look at his signature, there is a strong duty on the depositor to notify the bank of any loss or theft. There is nothing in the NIL at the present time which would specifically cover a situation of this kind. However, when necessary in the past, the courts have modified basic rules of the NIL through the application of the standard rules as to negligence. In the example given, and assuming the duty to notify the bank, the depositor would clearly be negligent and thus should bear the risk inherent in the situation. Probably the courts would reach this result.

It is interesing to note that in the revised NIL, contained in the proposed Uniform Commercial Code, there is a section which comes very close to solving the difficulties here considered. This is Section 3-406 and reads as follows:

"Negligence Contributing to Alteration or Unauthorized Signature.

"Any person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor who pays the instrument in good faith and in accordance with the reasonable commercial standards of the drawee's or payor's business."

The above is a new section, there being nothing comparable

in the NIL. The comment which indicates the thinking behind it follows.

> "The section applies the same rule to negligence which contributes to a forgery or other unauthorized signature, as defined by this Act (Section 1-201). The most obvious case is that of the drawer who makes use of a signature stamp or other automatic signing device and is negligent in looking after it. The section extends, however, to cases where the party has notice that forgeries of his signature have occurred and is negligent in failing to prevent further forgeries by the same person. It extends to negligence which contributes to a forgery of the signature of another, as in the case where a check is negligently mailed to the wrong person having the same name as the payee. As in the case of alteration, no attempt is made to specify what is negligence, and the question is one for the court or the jury on the facts of the particular case."[3]

There is ample precedent for the application of the rules of negligence or estoppel to negotiable instruments. As indicated in the comment set forth above, negligence may arise from a failure to prevent repeated forgeries. Another situation where the courts have applied rules of negligence is in relation to Section 15 of the NIL. This section concerns the nondelivery of uncompleted instruments and reads as follows:

> "*Incomplete Instrument Not Delivered*—Where an incomplete instrument has not been delivered it will not, if completed and negotiated, without authority, be a valid contract in the hands of any holder, as against any person whose signature was placed thereon before delivery."

Although the cases are not entirely uniform, the courts have not hesitated to moderate the rigorous nature of this rule in situations where the depositor has been found to be negligent.[4] The result suggested above where coded checks are used is a logical extension of rules already recognized by the courts in the area of negotiable instruments.

A question exists as to whether the solution here suggested

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[3] The pertinent portion of Section 1-202 reads " 'Unauthorized signature' means a signature made without actual, implied or apparent authority and includes a forgery."

[4] A collection of cases in this area is found in *Beutel's Brannan Negotiable Instruments Law, Seventh Edition* (1948 page 357 *et seq.*)

should be dependent upon whether the person presenting the check is a holder in due course.[5] Probably this should not be of any importance, since it does not in any way minimize the negligence of the depositor and presents a question which is almost impossible for the drawee bank to determine at the time of presentment. A fair solution would be to allow the bank to charge the account of the depositor regardless of the status of the person presenting, but allow the depositor a right of action over against the holder, with the depositor to prevail if the holder is not a holder in due course. To reach this result legislation may be necessary and is certainly something to be considered when possible amendments to the NIL are being reviewed. In a sense this question also relates to the rule of *Price* v. *Neal*, which is considered a little later in this article.

Another question has arisen where someone is able to counterfeit a check bearing a magnetic number of an actual depositor. Here it appears obvious that the bank would have no right to charge the item against the account of the depositor since what has been presented is a complete nullity, i.e., a counterfeit document bearing a forged signature. After payment by the bank, the question of whether the bank could claim the funds back from a holder in good faith for value, is doubtful under the law as it exists at the present time. This again relates to the basic rule of *Price* v. *Neal* subsequently considered.

From a practical standpoint, the counterfeit operation will probably not occur with any frequency. This is true because of difficulties inherent in the manufacture of magnetic ink and the requirement for special printing machinery. While counterfeiting here may not be as difficult as counterfeiting United States currency, there are substantial obstacles in the path of anyone inclined in this direction.

Another situation is where coded checks are lost or stolen and the depositor has no knowledge of this and has not been negligent in the care and custody of his checks. Here the reasoning where the depositor has knowledge of the loss or theft and has failed to notify does not apply and it would appear

[5] It is recognized that there may be a conceptual difficulty in terming the holder of an instrument bearing a forged maker's signature a holder in due course; however, common usage supports this terminology.

that the bank would not be entitled to charge the check bearing the forged drawer's signature against the account of the drawer. On the other hand where the depositor has been negligent in the care or custody of the coded checks, a strong argument can be made that the rule should be the same as that where the depositor knows of the theft and fails to notify the bank. This question appears open at the present time and will be resolved in the future by either the courts or legislatures. Undoubtedly as a matter of practical operation banks will require agreements from depositors wherein they agree to observe certain standards of care in relation to the custody of coded checks and if these standards are departed from, the risk of loss passes from the bank to the depositor. It is recognized that the courts have been somewhat loath to give standing to agreements varying the provisions of the NIL; however, in this area there would appear to be no public policy which would prevent such an agreement.[6] There can be no question but that in view of the nature of the risks involved, a greater duty as to care and custody exists as to coded checks than is the case for ordinary checks. On the other hand, because of public relations and competition, banks may elect to bear this risk.

At this point the reader may well be saying to himself, this is something I don't like. In the case of facsimile signature checks I request them; however, here the bank is thrusting coded checks on me regardless of whether I wish them or not and possibly my responsibilities are being increased. The answer is that if checking services are to be made available to the general public at a reasonable cost, automation is necessary; in turn, automation may create additional risks. Service charges on checking accounts have largely been on a stop loss basis and there appears to be no intention to change the same. On the other hand when new business conditions develop, there may well be changing responsibilities. In a sense the situation is similar to what has developed with regard to the use of automobiles. Whether one likes it or not, insurance is manda-

[6] It should be noted that the courts have gone both ways as to agreements limiting responsibility in relation to stop payment orders. See 1 ALR 2d 1150 *et seq. Hiroshima* v. *Bank of Italy* (1926) 78 Cal. App. 362, 248 P. 947. For limitations as to agreements that a statement of account will be conclusive after a period of time, see *Basch* v. *Bank of America* (1943) 22 Cal. 2d 316, 139 P. 2d 1.

tory in many areas and this was not true twenty years ago. This can be avoided by taking taxis; however, the convenience of an individual automobile overrides the cost and responsibilities involved and this would seem to be true of a checking account.

Originally, and from the standpoint of evidence, some concern was felt over the fact that in the apparatus here used the evidence of a present balance in a depositor's account consisted of invisible molecules arranged in a certain pattern in a magnetically sensitive medium. Increases or decreases in the account balance would again be the results of changes of molecular pattern. However, any fear in this direction appears to be obviated by the fact that there will always be pieces of paper, i.e., deposit tags and checks, to evidence deposits and withdrawals. In view of this existence and preservation of original instruments, the situation from the standpoint of evidence is certainly superior to, for example, that which exists in relation to the use of radar in connection with traffic violations and an electric meter in recording the amount of electricity used in a home. Curiously enough it was the electric house meter which suggested electronic computing devices, since it was one of the first instruments to convert electrical impulses into Arabic numerals.

A final point to be considered is whether there should be some relaxation of the rule of *Price* v. *Neal* where coded checks are utilized. *Price* v. *Neal,* decided in England in 1762, states that when the drawee has paid the holder of a forged bill of exchange, the transaction is final and the bank may not recover from the holder under the usual rules as to money paid under mistake of fact. Referring again to the Uniform Commercial Code which continues *Price* v. *Neal,* it gives a succinct statement of the reasoning behind the rule as follows:

> "The section follows the rule of Price v. Neal, 3 Burr. 1354 (1762), under which a drawee who accepts or pays an instrument on which the signature of the drawer is forged is bound on his acceptance and cannot recover back his payment. Although the original Act is silent as to payment, the common law rule has been applied to it by all but a very few jurisdictions. The traditional justification for the result is that the drawee is in a superior position to detect a forgery because he has the maker's signature and

> is expected to know and compare it; a less fictional rationalization is that it is highly desirable to end the transaction on an instrument when it is paid rather than reopen and upset a series of commercial transactions at a later date when the forgery is discovered."[7]

Obviously the first ground for the rule stated above has been a semi-fiction for some time and becomes more so with the use of coded checks and the great increase in volume. It is a long time from 1762 to 1959 and the tempo of business today is certainly entirely different from that in a private banking house in England almost two hundred years ago.

The second argument in support of *Price* v. *Neal* is that it is desirable to have a finality as to business transactions, particularly those involving negotiable instrument. This argument appears to be more theoretical than real. It is in about the same category as being opposed to sin. In other words, it is desirable but is not the case in many, many transactions. For example, in so far as a forged endorsement on a check is concerned, the transaction of payment is not final and the item may be charged back against the person presenting within varying periods of time, depending upon local statutes of limitation. The United States Government takes the position that it has six years within which to return an item on which the endorsement is forged. The renegotiation of government contracts involving millions of dollars is another example.

Certainly where the person presenting had theretofore given value for the instrument it would appear that his loss is truly the result of his faith and confidence in the person from whom he had received the check and that it cannot be said that his loss was proximately caused by the bank paying the check in error.

While it must be recognized that the rule of *Price* v. *Neal*, is firmly embedded in our jurisprudence as of today, it is interesting to note that approximately forty years ago there was some judicial comment to the contrary.[8]

In *American Express Co.* v. *State National Bank* (1911) 27

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[7] Comment Section 3-418 Uniform Commercial Code.

[8] In Pennsylvania *Price* v. *Neal* was in effect reversed by statute (Pa. Stat. Anno., Purdon Perm. ed., Title 56 § 29) until the adoption of the Uniform Commercial Code in 1954.

Okl. 824, 113 P. 711, the court, after stating the rule, went on to say:

> "The leading case sustaining this proposition is Price v. Neal, 3 Burr. 1354, decided in 1762. A great many of the courts that continue to follow the old rule criticise it, but follow it upon the ground that it has been established by decisions which have been so long acted upon that it is not proper to disturb them. All the text-book writers on banks and banking that we have access to disapprove the old rule as unsound and unjust. Mr. Morse says of it: 'This doctrine is fast fading into the misty past, where it belongs. It is almost dead, the funeral notices are ready, and no tears will be shed, for it was founded in misconception of the fundamental principals of law and common sense.' 2 Morse on Banks and Banking, § 464. Mr. Bolles says it is a hard rule. 'It runs against the great rule that money paid by mistake may be recovered back, which is constantly growing in judicial favor.'"

In *First National Bank* v. *Farmers' and Merchants' State Bank*, 146 S. W. 1034 (Court of Appeals, Texas, 1912) the court said:

> "But the magic name of Mansfield has not been sufficient to render perpetual the heresy taught by him. . ."

The existing rules in this area appear to be unfair and illogical and the adoption of coded checks and the consideration by the Legislatures of the Uniform Commercial Code afford an opportunity for revaluation.

Although the purpose of this article is only to consider forged items there are other questions which will inevitably arise. For example, when is a coded check paid? Certainly it would appear to be paid when the electronic memory device has been adjusted by the insertion of the check in the apparatus. In certain instances grounds for an earlier payment may be urged. In areas like New York a single bank having branches may use only one apparatus of the kind here considered. Checks would pass from each individual branch to a central location where the electronic equipment is located. After being processed the checks would be returned to the individual branches. There would be some logic in the contention that when not paid over the counter, a coded check should be deemed paid when it leaves an individual branch for the accounting center.

In conclusion and summary it may be said that the use of coded checks will or should cause very little change in existing law relating to negotiable instruments. This would appear to be a compliment to the skill and possible foresight of those who drew the original NIL: However, there may need to be some strengthening of the rules as to the depositor's responsibility for care and custody of coded checks and his duty to report loss or theft immediately. While one hesitates to raise an issue that has to a large extent been dead for forty years, it would also seem desirable that there be a new and searching look at *Price* v. *Neal*.

FRB APPROVES TIME DEPOSIT PRACTICE OF TRUST DEPARTMENTS

The Board of Governors of the *Federal Reserve System* has approved of trust departments of commercial banks placing on deposit funds which will be called for disbursement within a short time and placing funds which will not be needed right away in time deposits. The Board stated that in deciding whether or not to follow such a procedure ". . . the bank should be satisfied by consultation with its counsel or otherwise, that the time deposit is within the authority of the trust department in its capacity as trustee or agent—in other words, that it is not inconsistent with any applicable State law or with the terms of any applicable trust instrument or court order, in the case of trust funds, or agency agreement in the case of agency funds."

BANKING DECISIONS

In this department are published each month all of the important decisions of the Federal and State Courts involving questions pertaining to the law of banking and negotiable instruments. The experiences they disclose deserve careful attention and study of bankers, bank counsel, the depositor and the bank student seeking advancement.

Purported Drawer of Forged Check Has No Cause of Action Against Payee But Must Look to Drawee Bank

A construction company, the purported drawer of a check, brought suit against the payee alleging that the latter had deposited to the credit of its account with Central National Bank of Cleveland a check in the amount of $2,000, purportedly drawn on the plaintiff company's account with the Cleveland Trust Company. The construction company claimed that defendant payee received credit for the amount of said check; that the check was forged in that it was not drawn by anyone with authority to draw checks on the plaintiff company's account; that defendant-payee was not a bona-fide holder because it accepted the check in payment of a personal obligation of an employee of the plaintiff construction company. Plaintiff company sought judgment in the amount of $2,000.

Defendant-payee took the position that the complaint failed to state a cause of action. The lower court agreed with defendant and dismissed the complaint. On appeal, the judgment was affirmed.

The Court of Appeals of Ohio stated the doctrine of *Price v. Neal* to the effect that a drawee pays at his peril a bill on which the drawer's signature has been forged and pointed out that while there was a scarcity of Ohio cases dealing with the subject of *Price v. Neal*, the rule of that case was the unfailing rule in other states. The court concluded that "business usage and expediency demand that the bank pay at its peril." It

NOTE—For similar decisions see B. L. J. Digest (Fifth Edition) § 549.

reasoned that when the drawee honored the check, it paid out its own money and not any money belonging to plaintiff company. Plaintiff, in other words, suffered no loss because the drawee had no right to cash the forged check or to charge plaintiff's account therefor. The court stated that the plaintiff company was "relegated to its recovery against the drawee bank." *Kares Construction Co. v. Associates Discount Corporation,* Court of Appeals of Ohio, 163 N.E.2d 913. The opinion of the court follows:

GRIFFITH, J.—The appeal comes before this Court on questions of law from the Municipal Court of Cleveland which sustained a demurrer to plaintiff's amended petition and, when the plaintiff did not plead further, rendered judgment in favor of the defendant.

Plaintiff alleges that on December 4, 1957, the defendant caused to be deposited to the credit of its account with Central National Bank of Cleveland a check purported to be drawn upon plaintiff's account with the Cleveland Trust Company in the sum of $2,000 and, thereafter, received credit upon its account for said check; that the check in question was forged and not drawn by anyone with authority to draw upon or charge its account; that defendant was not a bona fide holder of said check, and that the check was accepted from one, Cogan, an employee of plaintiff's, in payment of Cogan's personal obligation without making any inquiry of the drawer. On these allegations, plaintiff sought judgment for $2,000 with interest.

To this petition, the defendant filed a general demurrer on the ground that the allegations did not state a cause of action. This demurrer was sustained and on April 24, 1959, judgment was entered for the defendant, and the plaintiff's action was dismissed.

The theory upon which the action is brought is quasi-contract, a suit for recovery, because the defendant has been unjustly enriched. Here the unjust enrichment consisted of a bank credit of $2,000 arising from a forged instrument, and the plaintiff cites 31 O.J. 218, 219. Second National Bank of Bucyrus v. New First National Bank, 7 Ohio App. 68, and Wheeler v. Miller, 2 Handy 149, in support of its contention.

The sole question presented in this appeal is whether the plaintiff may recover against the defendant, the plaintiff being the apparent drawer of the alleged forged check, and the defendant being the payee of said check.

The defendant's demurrer is based on the ground that plaintiff has no right of recovery and has failed to state a cause of action for these reasons:

1. Plaintiff paid no money or anything else to defendant and, therefore, cannot recover anything back from the defendant.

2. The drawee bank (The Cleveland Trust Company), had no right to cash the alleged forged check and to debit plaintiff's account therefor and, in contemplation of law, the plaintiff's funds are still on deposit with said drawee bank, and the plaintiff has suffered no loss.

The plaintiff alleges that the plaintiff had a checking account at the Cleveland Trust Company. The relationship set up between the bank and the plaintiff depositor is that of debtor and creditor, not of agent and principal. The money deposited became part of the bank's general funds, and the bank, in accepting the deposit, contracts at least impliedly to pay the depositor's check to the extent of the depositor's credit. Title to the money on deposit is in the bank and ceased to be moneys belonging to the plaintiff. See 7 O.J. (2d) 240, par. 106.

Defendant urges that the present case falls within the ruling of Lord Mansfield, then on the King's Bench, in England, decided in 1762, as enunciated in the famous case of Price v. Neal, 3 Burr 1354.

This doctrine, in few words, is that a drawee pays or accepts at his peril a bill on which the drawer's signature has been forged. This rule was early adopted in Ohio in the case of Ellis v. Ohio Life Insurance & Trust Co., 4 Ohio St. 628 and later followed in First National Bank of Belmont v. First National Bank of Barnesville, 58 Ohio St. 207, 50 N.E. 723, 41 L.R.A. 584.

Justice Story, in 1825, in the case of Bank of United States v. Bank of Georgia, 10 Wheat. 333, 6 L.Ed. 334, made the following statement:

> "After some research, we have not been able to find a single case in which the general doctrine of Price v. Neal has been shaken or doubted."

While there is a scarcity of cases in Ohio relating to or touching on Lord Mansfield's doctrine, it seems to be the law outside this state that the time and the place when mistakes and forgeries should be decided once and for all is when the drawee bank honors or dishonors the instrument. Business usage and expediency demands that the bank pay at its peril. General Fire Assurance Co. of Paris, France v. State Bank, 1917, 177 App.Div. 745, 164 N.Y.S. 871; F. J. Lewis Manufacturing Co. v. Pennsylvania Railroad Co., 1930, 258 Ill.App. 216; Bergstrom v. Ritz-Carlton Restaurant & Hotel Co., 1916, 171 App.Div. 776, 157 N.Y.S. 959.

Plaintiff alleges in its petition that the defendant was not a "bona fide holder" of said check, and that defendant accepted the check from one of plaintiff's employees without making inquiry of the drawer. This allegation, if proven, cannot change or improve the cause of action in the plaintiff.

There can be no recovery in this case by the plaintiff against the defendant for the reason that the plaintiff was not the holder of the title

of the money. When the bank paid the money on this check, it paid its own money and not any money belonging to the plaintiff, and the plaintiff has no cause of action against the defendant.

Since the plaintiff has suffered no loss, because The Cleveland Trust Company had no right to cash the forged check or to charge plaintiff's account for the same, the plaintiff is relegated to its recovery against the drawee bank.

Judgment affirmed.

DOYLE, P. J., and HUNSICKER, J., concur.

(DOYLE, P. J., HUNSICKER, J., of the Ninth District, GRIFFITH, J., of the Seventh District, sitting by designation in the Eighth District.)

Bank Recovers Overdraft Despite Connivance of Teller

The bonding company of a drawee bank sued the drawer, payee, and two endorsers who wrote on the back of the check, "Payment fully guaranteed by us as individuals." The check was presented by the payee to the drawee on at least two occasions and payment was refused because of insufficient funds. Ultimately the payee procured payment of the check with the connivance of one of the tellers of drawee although payment resulted in an overdraft in the drawer's account. The indemnitors made good the drawee's loss and brought the instant suit.

The court below held all the defendants jointly and severally liable. Upon the guarantor's appeal, the court stated that the bank in its payment of the check was not a volunteer and, even though the teller's act was inexcusable, it would be unfair to force the bank to pay the guarantor's debt to the payee out of its own funds because of the teller's complicity with the payee.

The court seemed to assume that the guaranty of payment by the endorsers ran to the drawee bank. Inasmuch as the drawee was only the agent of the drawer to pay the check,

NOTE—For similar decisions see B. L. J. Digest (Fifth Edition) § 1208.

it would seem that the guaranty and the normal warranties of endorsers did not run to the drawee. However, it is clear that the drawee (or its indemnitors) was entitled to be reimbursed by the drawer for the amount of the overdraft or by the payee because of the teller's unauthorized payment and the payee's fraud. *Presley v. American Guarantee & Liability Insurance Co.*, Supreme Court of Mississippi, 116 So.2d 410. The opinion of the court follows:

LEE, J.—American Guarantee and Liability Insurance Company and United States Fidelity and Guaranty Company, assignees of all rights, as indemnitors of Deposit Guaranty Bank and Trust Company in their bill of complaint against J. Douglas Dedeaux, Hugh H. Moore, Sam L. Presley, Jr., and P. D. M. Enterprises, Inc., sought to recover $2,941.69, being the amount of the bank's loss in connection with the payment with a check, drawn by the corporation, and guaranteed by Presley and Moore.

Presley filed both general and special demurrers, which challenged the sufficiency of the alleged cause of action, and, by his answer, denied the material allegations of the bill of complaint. Both P. D. M. Enterprises, Inc., and Moore filed general and special demurrers, and adopted by reference the answer of Sam L. Presley, Jr. Dedeaux filed no pleading. The demurrers were overruled. At the conclusion of the evidence, the chancellor made a finding of law and fact and adjudged that the defendants were jointly and severally liable. From the decree, which was entered in accordance with the finding, Presley and the corporation appealed.

The controversy arose in this way: Sam Presley, Jr., J. D. Dedeaux and Hugh Moore organized P. D. M. Enterprises, Inc., a corporation, with a capital stock of 30 shares of the par value of $100 each, and issued to each incorporator, upon payment of $1,000, 10 shares of the stock. Their purpose was to purchase an assignment of the lease, together with the personal property, and operate the business known as Cicero's Restaurant, in the City of Jackson. The consideration therefor was $30,000, payable $15,000 in cash and $15,000 secured by a promissory note, payable $400 per month, and bearing interst at the rate of 5 percent per annum.

Each of the incorporators, on September 8, 1956, loaned the corporation $4,000, and took, as security, the corporate note in that amount with interest at the rate of 5 percent per annum. They also made another loan of $700 each and took the corporate note therefor with the same interest rate.

The transaction was consummated, and Dedeaux, at a salary of $500 per month, operated the business from September 8, 1956, until January

8, 1957. In the meantime, dissension arose between Dedeaux and Presley. Finally, on a give or take proposition, Presley with the consent of Moore, acquired Dedeaux' stock and interest, in the name of the corporation, for a consideration of $7,500. In order to raise the money for this purpose, Presley and Moore were each to lend the corporation $3,750, which loans were approved by the minutes of the corporation.

Three checks, with the corporation as maker, drawn on Deposit Guaranty Bank & Trust Company of Jackson, were delivered to Dedeaux, as follows: One in the sum of $2,723.11, in payment of Dedeaux' 10 shares of stock; another, in the sum of $710.20, being the amount of the principal and interest on the corporation note of $700 to Dedeaux; and the third, in the amount of $4,066.69, being the principal and interest on the corporate note of $4,000 to Dedeaux of date of September 8, 1956. This third check was postdated as of January 22, 1957, and on the back was this notation: "Payment fully guaranteed by us as individuals", and signed by Sam L. Presley, Jr., and Hugh H. Moore.

Presley promptly paid the amount of his loan to the corporation, and, from the proceeds thereof, the checks for $2,723.11 and $710.20 were paid. Moore did not put up the money, which he agreed to lend. Consequently when Dedeaux, about January 22, 1957, or soon thereafter, presented the $4,066.69 check to the bank, payment was refused because of insufficient funds. Such refusal was stamped on both the face and the back of the check. At least on one other occasion, and perhaps on others, payment was again refused. Two such refusals were stamped on the back of the check.

Mrs. Marian Dedeaux, 32 years of age, had been married to Dedeaux for 18 months, and they had one child. She had worked in several banks, and had been employed by the Deposit Guaranty Bank & Trust Company for about 10 years. She was having marital trouble, and admitted that in April 1957, she had a conversation with Hugh Moore, in Cicero's Restaurant, in which he told her that no more money was to be paid on the $4,066.69 check. But her husband told her that there was, and she took his word for it. She admitted that her husband had also told her that Sam Presley, Jr., had paid everything that was due and did not owe anything else. She also knew that Sam Presley, Sr., in July 1957, had loaned her husband some money.

Mrs. Dedeaux testified that she and her husband had been separated, but that they had gone back together, and her husband had told her that he wanted to straighten out and "make a go" of the marriage, and that she also wished to do so; that her husband went to New Orleans, and, on his return, on Wednesday, September 25, he told her that he had gone through Mobile to see Sam Presley, Sr., who had agreed to deposit money to pay the check in order to prevent a suit against Sam Presley, Jr.; that on Thursday night her husband told her that he had been to a

lawyer's office to straighten out the legal ends of the check, and that Mr. Presley "was going to make the deposit Friday morning"; and that he also told her that he had to have the money out of the check. (Actually, Dedeaux had become involved with some New Orleans gamblers who had assaulted him on account of a gambling debt of $2,500, and had threatened to kill him if he did not pay it; and he had told several people about this incident, but he denied that he told his wife. She said that he told her "that he ran into a post in Wiggins, Mississippi, playing baseball".) She further testified, that when her husband came into the bank Friday morning, September 27, 1957, to her as teller and presented the check, "he told me that Mr. Presley had, or either was going to make, the deposit that morning. I would not swear to it because I don't remember which he said. I asked him where the deposit would be made, and he said it would be made probably at one of our branches". She admitted that she looked at the check, saw that it had been turned down on account of insufficient funds, consulted no one, and made no effort to determine whether there were sufficient funds at that time in the P. D. M. Enterprises, Inc., account to pay it. She said that she relied on her husband's representations—"I relied on the deposit being made". Thereupon she cashed the check, in the amount of $4,066.69, and gave the money to her husband, who deposited $1,100 to his account, gave her $250 with which to pay the note of $100 on the house, $100 for her expenses, and $50 to be given to his mother on a debt that he owed her. The balance he put in his pocket, and, as he departed, he said that he would be back by Sunday and they would go to Church. He left, and she did not see [him] again until sometime the following February.

Dedeaux testified that he told his wife, on the night of September 26, 1957, that he had talked to Sam Presley, Sr.; that this man was going to make a deposit on the check; and that, when he went into the bank the next morning, with his face "in a kind of beat up condition", he told his wife "that the money would be deposited". He admitted that he told his wife that Sam Presley, Sr., was going to make the deposit, but, "I didn't know whether the money was in the bank or not"; and that it was a lie that he told her about the deposit. He admitted that he paid $2,500 of the money to the gamblers. He identified a note dated July 20, 1957, which he had given to Sam Presley, Sr., as evidence of a loan to him in the amount of $2,000, and which was apparently assigned to Sam Presley, Jr. He admitted that he had not claimed that Sam Presley, Jr., owed him anything. (This does not mean that he was exonerating Presley from his guaranty. He knew that Presley had loaned the corporation one-half of the purchase price to be paid, and that, morally speaking, Presley had paid his one-half of the amount of the consideration.)

On the following Monday, the bank discovered that the check had

been cashed. The cashier told Mrs. Dedeaux that she did wrong in cashing it, and that she should have referred the matter to an officer. She was discharged on the following Thursday.

The cashier, on October 3, 1957, advised the appellee insurance companies of the loss by reason of the cashing of the check, and that Dedeaux' account of $1,125 was charged with the item, thus reducing the loss to $2,941.69. The insurance companies paid the loss and took an assignment of all the rights of the bank.

Thomas I. Kent, the representative of American Guarantee & Liability Insurance Company, testified that the loss was paid under section (B) of the policy, the "false pretense" section, for the false pretenses, if there were such, on the part of Dedeaux; and that he gave no consideration to the endorsement on the back of the check. Lee G. Kirk, the representative of United States Fidelity & Guaranty Company, testified that the loss was paid under clause (B) because of the false pretenses of Dedeaux, saying that it was made because the bank lost money.

The appellants argue strenuously that the appellees paid the bank's loss on account of the false pretenses of Dedeaux; that, in fact, there was no false pretense under the law, and certainly none on the part of Presley and Moore; that the bank and its teller knew that P. D. M. Enterprises, Inc., did not have sufficient funds in the bank to pay the check; that there was collusion between Mr. and Mrs. Dedeaux in order to get the money so that Dedeaux could pay his gambling debt; that the bank, in making the payment, was a volunteer; and that the appellants are therefore not liable.

It is true that, on the date that the check was given, the corporation did not have the money to pay it. Dedeaux knew that. Clearly he accepted the check as an acknowledgement of the debt. When, on January 22, 1957, or soon thereafter, he presented it, payment was refused because of insufficient funds, and notice of such insufficiency was stamped across the face and back of the check. When he presented it later, payment was again refused for the same reason, and notice thereof was again stamped on the back. On September 27, 1957, over eight months after the date of the check, it was again presented by him. He then knew that there were not sufficient funds in the bank to pay it. His wife saw that the check itself, from the notations thereon, showed that payment had been twice previously refused because of insufficient funds. Besides she knew that the money was not then in the bank because Dedeaux told her that Sam Presley, Sr., was going to make a deposit to take care of the check. She made no effort to find out whether such deposit had, in fact, been made at the time. She did not consult a superior. It is almost incredible that Mrs. Dedeaux, after ten years of banking experience, could ignore the cardinal rules of her occupation, heed the request of her husband to cash this particular check on

his statement that Sam Presley, Sr., was going to make a deposit to take care of it, and deliver to him $4,066.69 of the bank's money. Yet, that is her story. If true, she is naive indeed.

It is also true that, in a criminal prosecution for obtaining money or other valuable thing under false pretenses, "The pretense must be a representation as to an existing fact or past event, and not as to something to take place in the future; and it must be a representation as to a material fact." 35 C.J.S. False Pretenses § 8, p. 646; Hammack v. State, 114 Miss. 611, 75 So. 436; McArthur v. Fillingame, 184 Miss. 869, 186 So. 828; Button v. State, 207 Miss. 582, 42 So.2d 773.

The above principle would have been applicable in a prosecution against Presley and Moore, if they had been jointly indicted with Dedeaux for obtaining the money from the bank under false pretenses. But the fact remains that they, in no way, colluded or conspired with Dedeaux. They had nothing whatever to do with his obtaining the money from the bank and the way and manner in which he did so. See McCain v. Cochran, 153 Miss. 237, 120 So. 823.

On the other hand, the appellees contend that the check was a valid negotiable instrument, issued for a good and valid consideration, namely, the purchase price pro tanto of Dedeaux's interest in the corporation; that P. D. M. Enterprises, Inc., was clearly liable thereon; that Moore and Presley were liable as guarantors, and that notice of dishonor was not required; that, under the law of subrogation, they are entitled to recover against all of the appellants; and that, while the court was justified in holding all of the appellants to be guilty of fraud, this was not necessary as the liability of the appellants is based on a contract.

The check was clearly a part of the consideration for the purchase of Dedeaux' interest in the corporation. Under Sections 167 and 226, Code of 1942 Rec., it was a bill of exchange; and, under Section 42 of the Code, it was negotiable. Of course it had to be presented for payment within a reasonable time. Section 227, Code of 1942 Rec.

The check was postdated at the time when Dedeaux received it, and he, of course, was apprised of the fact that the corporation did not have funds in the bank to pay it. However, it constituted an acknowledgment of the debt, and was not invalid. Section 53, Code of 1942 Rec. Obviously Dedeaux had the right, upon its nonpayment, to sue either upon the check itself or the original consideration. 8 Am.Jur., Bills and Notes, Section 523, page 238. Compare Parrish v. Feldman, 182 Miss. 77, 180 So. 610, 181 So. 336.

While payment of the check was refused on several occasions because of insufficient funds, Presley and Moore at no time ever stopped payment on it. There was no plea of payment, and it had not been paid. Sam Presley, although present, did not testify. By reason of their stated endorsement on the back they were guarantors. 10 C.J.S.

Bills and Notes § 39b, p. 470; 38 C.J.S. Guaranty § 18b, p. 1157.

The guaranty inured to the benefit of a subsequent holder. In 38 C.J.S. Guaranty § 42b, p. 1189, it is said: "Where a guaranty is written or indorsed on a negotiable bill or note, it is negotiable in the sense that it inures to the benefit of seccussive holders of the bill or note. According to some decisions, a guaranty indorsed on a note which is general and unrestricted in its terms passes by assignment and delivery of the note to a subsequent bona fide holder thereof, although nothing is said touching the guaranty, and although he was ignorant of the guaranty at the time of his purchase." See also Baker v. Kelly, 41 Miss. 696; Holmes v. Preston, 71 Miss. 541, 14 So. 455; Quinn v. Alexander, 125 Miss. 690, 88 So. 170.

Of course both the bank and its assignees, the appellees, took the check, subject to such defenses as might have been offered against it in the hands of Dedeaux. See 38 C.J.S. Guaranty § 42b, p. 1189, where it is said in part: "So the assignee takes the guaranty subject to all the defenses which might have been interposed against it in the hands of the assignor."

The witness Moore, in justification of his failure to make his loan of $3,750 to the corporation, testified that he had a secret agreement whereby Dedeaux would hold the check and keep an interest in the business, unknown to Presley. But the chancellor, in his finding of facts, said that he had observed the demeanor of this witness, and, in his opinion, there was not a word of truth in his statement.

It is true also that Dedeaux, during cross-examination, identified a note, dated July 20, 1957, which he had made to Sam Presley, Sr., for a loan of $2,000, and which was apparently assigned to Sam Presley, Jr. While this note was admitted in evidence with the right to substitute a photostatic copy, the copy was not furnished; and because "the original had been returned to his client" with the consent of counsel, this exhibit was not attached. Thus the due date of the note, and whether it was still owned by Sam Presley, Jr., does not appear in the record.

Obviously no sufficient defense against the check or its guaranty was pled or proved.

When the appellees paid the bank's loss, by the doctrine of subrogation, they were vested with all of the rights of the bank against the named defendants. This principle has aptly been said to be "a creature of equity, and is the mode which equity adopts to compel the ultimate payment of a debt by one who, in equity and good conscience, ought to pay it." Oxford Production Credit Ass'n v. Bank of Oxford, 196 Miss. 50, 16 So.2d 384, 388, and authorities there cited.

The bank, in its payment of the check, was not a volunteer. A voluntary payment is the payment of a demand, which the payor does not owe and which is not enforceable against him, without any agreement at the time that any excess will be repaid, and without compulsion or

fraud or any mistake of fact, instead of invoking the applicable legal defenses. McLean v. Love, 172 Miss. 168, 157 So. 361. Conceding that the teller's act, in paying out the bank's money under the circumstances, was utterly inexcusable, the fact remains that the liability of the appellants to Dedeaux, to the extent of the amount adjudged by the decree, was discharged out of the funds of the bank. Manifestly the denial to the bank or its indemnitors of their right to recover for the amount of the appellants' liability, which they extinguished, would be contrary to equity and good conscience. Robertson v. Sullivan, 102 Miss. 581, 59 So. 846, and authorities there cited.

In view of the conclusion here reached, it is unnecessary to deal with the appellants' other contentions as, in the present situation, they have ceased to have any direct bearing on the applicable principles of the case.

The appellees prosecuted a cross-appeal, contending that they are entitled to interest from January 22, 1957, the date of the check, whereas interest was allowed at the rate of 6 percent from the date of the decree. They cite Burton v. Eureka Bank, 122 Miss. 393, 84 So. 247. But the action in that case was based on a note, which provided for interest at the rate of 8 percent per annum. The action in the present case is based on a check which contains no provision for interest. Consequently Section 39, Code of 1942 Rec., governs, and interest can be allowed only from the date of the decree.

It therefore follows that the cause must be affirmed on both direct and cross-appeals.

Affirmed on both direct and cross-appeals.

ROBERDS, P.J., and KYLE, ARRINGTON and GILLESPIE, JJ., concur.

MICHIGAN LIMITS RANGE OF MOBILE BANKING SERVICES

The Attorney General of Michigan has ruled that state banks may not use special trucks, trailers or similar units to provide mobile deposit, lending or check cashing services to the public. According to his opinion such activities might well be construed to constitute branch banking which is forbidden by the State Financial Institutions Act. Moreover, States banks may not use mobile units for the pick-up and delivery of large sums of money such as store deposits or company payrolls.

Banks Entitled to Rely Upon Certificate to Corporate Banking Resolutions

Personal Typewriter Company was imperfectly organized in that, among other things, organization minutes were never signed and stock certificates were never issued. Plaintiff, the trustee in bankruptcy of Personal, sought to impose liability upon two banks for the amounts of certain checks drawn on Personal's account with each of the banks because of the lack, in one case, of a certificate to corporate banking resolutions signed by the directors and, in the other, because of an incomplete resolution which failed to list the names of the holders of one hundred per cent of the capital stock of the corporation.

Each of the banks prevailed over the trustee in bankruptcy. In the case of the certificate which did not bear the signature of the directors of Personal, the court held that the bank was not on notice that the board of directors had not approved the resolution and that the bank was justified in relying on the apparent capacity of two de facto officers to execute the resolution.

The incomplete resolution authorized the bank to accept checks drawn to the order of Personal for deposit in the account of another corporation. When the certificate was delivered to the bank, it was stated to the bank that the consent of the stockholders of Personal to the resolution was needed. The court held the resolution to be valid and stated that the bank had no duty to procure the consent of the stockholders of Personal. The court also held that the bank was not negligent in accepting checks for deposit in accordance with the resolution. *Otte v. Franklin National Bank of Franklin Square,* United States District Court, E.D. New York, 179 F.Supp. 381. The opinion of the court in part follows:

BYERS, D. J.—These cases were consolidated for trail (Pre-Trial Order, May 14, 1959) which proceeded on October 21, 22 and 23. Final briefs were filed on November 17, 1959.

NOTE—For similar decisions see B. L. J. Digest (Fifth Edition) § 372.5.

The court has not been provided with the minutes of the trial. There are eleven so-called briefs and memoranda before the court, none of which contains a concise chronological statement of all the facts.

It the first action (complaint filed April 4, 1958) the trustee seeks to recover from the two banks, to be called Franklin and Commercial, respectively, the sums of $9,747.20 and $11,382.90, as asserted in the fourth and fifth causes of action pleaded in the complaint. As to the Franklin, judgment is also sought against the individual defendants Levy and Siegel jointly with the bank.

There is also a complaint (filed June 27, 1958) and answer (filed Sept. 15, 1958), No. 18826 (the second cause) wherein the trustee seeks judgment against Funds to recover $9,682.74 said to constitute a preferential payment under the Bankruptcy Act, 11 U.S.C.A. § 1 et seq.

In No. 18608 the Franklin Bank has filed its third-party complaint (Feb. 5, 1959) against Funds, seeking relief against it, in the event of being held liable to the plaintiff.

The plaintiff's main theory is understood to be that these banks permitted the bankrupt and Northern (later described) to operate their accounts without exact compliance with certain formal requisites such as resolutions of the directors, etc., as a result of which the checks deposited in Franklin were used to meet a corporate check drawn to the order of Funds for Business, Inc., to be called Funds, and collected by it. As to the Commercial account, that the checks drawn cannot now be shown to have been applied to the corporate purposes of Personal. This will be discussed below.

As to neither account is there an assertion that the bank itself benefited in any way from the criticized handling of corporate deposits; this means that there was no transfer to either bank which could be attacked under the Bankruptcy Law.

The depositor, as to Franklin, was Personal Typewriter Co., Inc., to be called Personal.

That was a New York corporation as to which a certificate of incorporation under another name was filed on August 30, 1956 and thereby corporate existence was created. The capital stock was said to consist of 200 shares of no par stock; the original name was changed to Personal on or about September 14, 1956. There were organization minutes prepared but never signed. Directors' minutes dated September 10, 1956 were likewise prepared but also not signed, which recite the election of Hyman Gardner as president and John O'Rourke as secretary-treasurer. No stock certificates were issued, but as of about the last mentioned date Gardner and O'Rourke acted as the only two officers and stockholders of this incompletely organized corporation. They may be regarded as de facto officers for the purposes of this case, but they were not careful in signing corporate papers to distinguish between the offices of president, vice-president, or secretary and treasurer.

They were the officers and probably the principal stockholders also of Midland Commercial Corporation of Newark, New Jersey, to be called Midland, which among other things was financing several enterprises, one being Northern Appliance Stores, Inc., to be called Northern. That was a subsidiary of Midland, marketing Underwood typewriter machines and similar devices. Its store was in Great Neck, Queens County, and nearby was the store of Personal.

The purpose of creating Personal was to sell Remington Rand typewriters which Northern was not supposed to do since it was an Underwood machine distributor.

The organization of Personal was in the nature of a subterfuge and these two enterprises were really operated jointly at the separate addresses, and it is difficult to believe that in the practical sense Remington Rand was unaware of the true facts. There is testimony to the contrary.

An understanding of this situation, which has not been too clearly brought to light, is the necessary basis of an approach to the somewhat casual attention given by the banks to their handling of these two accounts. The period of time involved in these transactions comprises the months of December 1956 and January and February, 1957 and it was during that interval that the individual defendants, Siegel and Levy, took over the stockholdings of Gardner and O'Rourke in Midland and management and control of that corporation, but the approximate effective date cannot be stated; as an incident thereto, Siegel and Levy took over the practical operations of Northern and Personal, which it is to be remembered was a mere adjunct of Northern. There is no doubt that this is what took place, but there is a deficiency in records from which the time could be established.

Thus it was that these two men succeeded to whatever official status attached to Gardner and O'Rourke as de facto officers of Personal, but the steps by which that result was accomplished are not clearly stated.

The relationship between Personal and Funds is presented in the first case, and requires decision in the second, because the theory of Franklin as third-party plaintiff is that if liability is to be visited upon it because of the way in which the account was handled, that liability must ultimately be visited upon Funds.

Franklin Bank Matter

Funds was the factor of Personal by reason of arrangements to that end initiated by the said Hyman Gardner, in the course of which he represented that Personal was a wholly owned subsidiary of Midland, and that the latter was a publicly held corporation whose stock was traded "over the counter," and of which corporation he was secretary and O'Rourke president; also that he and O'Rourke would personally guarantee the payment of any loans made by Funds to Personal.

A Dun and Bradstreet report procured by Funds, indicated that Midland had a net worth of over $460,000, upon which showing a factoring agreement dated December 6, 1956 was entered into between Funds and Personal, and the personal guarantees of Gardner and O'Rourke and Midland were endorsed thereon.

Between December 10, 1956 and January 17, 1957 Personal, by the terms of a factoring agreement in evidence, assigned to Funds its accounts, namely, its receivables from Remington Rand for sales commissions above referred to, the total of the assigned accounts being $51,917.-61, and against these assignments Funds advanced to Personal during the same period, a total of $31,150.

Of the customer contracts under which Personal had earned the selling commission, Remington Rand had accepted by about February 1, 1957 a total of $9,731.90, and forwarded checks for that amount to Personal. Those checks were deposited in the Personal account and against that total Personal drew its check for $9,682.74 in favor of Funds for application to the advances above described of $31,150.

It is this transaction to which the trustee objects and as to which he seeks to hold the bank liable.

This account was opened February 6, 1957 and the signature card bears the names of Murray J. Levy as president and Robert Siegel as secretary-treasurer of Personal. Seemingly but two deposits were made:

February 6, 1957	$9,408.62	
February 7, 1957	49.16	
	274.12	$9,731.90

The said pre-trial order lists the contested issues of law against this bank as follows:

1. The legal effect of the resolution pursuant to which this account was opened and the payment of the said check of February 13, 1957 to the order of Funds which was signed by the defendant Seigel as secretary of the bankrupt.

The signature card is regular on its face and there was no special circumstance to cause the bank to challenge the capacity of Levy and Siegel so to open the account. Siegel had been known to the bank for a considerable period of time so that it was not dealing with a stranger, and nothing is shown in the evidence to justify special inquiry on the part of the bank as to Siegel's status as an officer of Personal.

It is to be remembered that the check to Funds was not an instrumentality for diverting corporate funds for the benefit of either Siegel or Levy, as was true as to certain individuals in the cases of Wen Kroy Realty Co. v. Public National Bank, etc., 260 N.Y. 84, 183 N.E. 73; Wagner Trading Co. v. Battery Park Nat. Bank, 228 N.Y. 37, 126 N.E. 347, 9 A.L.R. 340; Fidelity & Deposit Co. of Maryland v. Queens County Trust Co., 226 N.Y. 225, 123 N.E. 370; Susquehanna Line, Inc. v. Auditore, 223 App. Div. 585, 229 N.Y.S. 181.

The use that was made of this check was payment of a corporate indebtedness of Personal, and that result could well have come about even though the bank had insisted upon the holding of a directors' meeting of Personal in the bank's offices and the proper adoption of a resolution by the directors. In other words, the lapse, if such it was, in failing to exact from Personal a completely formal corporate proceeding was of no benefit to the bank, nor did it result in other than a conventional application of Personal funds to the payment of a Personal debt.

The answer to the first question is that the legal effect of the reliance of the bank upon the certificate filed by Levy and Siegel on the part of Personal on February 6, 1957, for the purposes of this case, is found to have been sufficient to justify the bank in opening the account and in paying the said check to Funds.

2. Were Siegel and Levy de facto officers of the bankrupt and duly qualified to execute the resolution?

The evidence is not clear enough to answer this question categorically; they acted as and are deemed to have been de facto officers, and the bank was justified in relying upon their apparent capacity to execute the said resolution.

The said order lists questions of fact as follows:

1. "Was the bank on notice that the bankrupt's board of directors had not approved the resolution?"

The answer to this question is negative.

2. "Was the bank acting in good faith in accepting this account from the defendants Siegel and Levy on the faith of the corporate certificate above mentioned, or was it in fact relying solely on its past relationship with the defendant Siegel, who was known to them and who had been doing a substantial business with the bank in his own name or under corporate guise?"

The answer to this question is in the affirmative as to the good faith of the bank, and also that the latter relied in part upon its earlier relationship with the defendant Siegel.

3. "Is the bank liable to the plaintiff for the proceeds of said checks by reason of subdivisions (1) and (2) of this paragraph?"

The answer to this question is in the negative.

Subdivisions (c) and (d) of this question need not be answered in view of the foregoing.

Since the plaintiff cannot succeed against Franklin in its main cause, the third-party action against Funds is necessarily concluded by this holding. The question of the liability of Funds will be later discussed.

Commercial Bank Matter

The evidence does not disclose when this account was opened by Northern, nor does it appear what balance, if any, was in that account on November 21, 1956.

On that date, what purports to be a resolution entitled, "Certificate of resolutions authorizing deposit of checks or other commercial paper payable or endorsed to the order of corporations" bearing the corporate seal and the signature of Hyman Gardner as secretary and certified by John M. O'Rourke as president of Personal, was received and filed by the bank. That resolution provided in part as follows:

> "1. That Commercial State Bank and Trust Company of New York is hereby authorized to receive from Northern Appliance Stores, Inc. (hereinafter referred to as 'depositor') any and all checks, . . . payable to this corporation (namely Personal) or to its order when bearing the apparent endorsement of this corporation either by handwriting, typewriting, stamp impression or by any other means, with or without the signature of any person purporting to be an officer or agent of this corporation."

The following provisions refer to the authority of any officer or agent of the depositor, and the capacity of the bank to assume without inquiry the validity of deposits and withdrawals pursuant to the resolution, and that the secretary is authorized to certify and deliver copies of these resolutions to the bank.

What was accomplished by the above resolution was the deposit of checks drawn to the order of Personal in the account of Northern. That result could have been brought about by the deposit of Personal checks in a Personal bank account, and the drawing of checks against that to the order of Northern, and the deposit thereof in a Northern account. In other words, the practice initiated under the resolution was a shortcut to a transfer of Personal checks into the account of Northern, which would have been a questionable transaction but for the fact that during the months involved the affairs of these two corporations were really conducted as one, in order that the typewriter business of Northern might be expanded so as to embrace the selling of Remington Rand machines under the ostensible auspices of Personal. This being true, the commingling of the funds of the two corporations was a natural incident, and the criticism leveled against the bank for acting pursuant to the resolution of November 21, 1956 must be understood in the light of these actualities.

It is stated in the brief for the bank that checks did not come in for deposit until December 11, 1956, the last one being dated January 18, 1957; meanwhile, $11,382.91 had been collected in checks payable to Personal and so credited to Northern.

After the latter date, the bank refused further to conform to the resolution for the reason that the consent of stockholders of Personal which was stated to be necessary at the time of the filing of the resolution, was never obtained.

The excuse given by the officers of Personal for so failing was that since Midland was a publicly owned corporation, the consent of its stockholders could not be obtained as a practical matter. That excuse is not convincing, for the reason that Midland was the only stockholder of Personal, and its consent would not have been difficult to obtain.

There is to be said that as a matter of law the chances are that a stockholders' consent was not actually necessary because the evidence is that the bank was so advised at a later date; this means that the action of the bank in failing, after January 18, 1957, to credit Personal checks to the Northern account, was consistent with its earlier stated requirement, and therefore with careful attention to the handling of the account.

What is more convincing to this court, however, is that this record does not present any evidence whatever that checks drawn by Northern against these deposits were not used for the corporate purposes of Personal and/or Northern in connection with the operation of Personal, namely, the cost of advertising and maintaining records, salesmen's commissions, and the like; that is to say, as to this bank account there is no proof that the proceeds of the checks which were payable to Personal, found their way in any guise into the pockets of officers of either corporation or were otherwise diverted from the business of Personal. It is probably unnecessary to repeat that Commercial as a bank received no benefit whatever from the course of dealing which has been explained.

The trustee has produced no figures whatever, constituting or resembling a balance sheet of either Personal or Northern (in the absence of schedules in bankruptcy that is easily understood) to demonstrate that Personal was insolvent at the time that the foregoing resolution was acted upon by the bank, or indeed at any established date prior to the filing of this petition in bankruptcy which occurred in the month of April, 1957. In other words, there is no showing of any equitable reason why the court should be astute to find technical defects in either the resolution itself or in the conduct of the bank in rendering banking services in faith thereof.

Since an action for money had and received, which is the description appearing in the pre-trial order, involves equitable concepts, the plaintiff's case is lacking in this fundamental requirement.

Technically, if Northern failed to apply the proceeds of the checks so deposited in its account, for the benefit of Personal, a cause of action might exist in favor of the latter against Northern, but certainly nothing has been adduced to demonstrate a cause of action by Personal against Commercial.

The pre-trial order lists the following contested issues of law against this bank:

1. The validity and effect of the resolution above described.

In the opinoin of this court, while the resolution is incomplete in failing to list the names of the holders of 100% of the capital stock of

the company, it nevertheless bears the seal of the corporation and was signed by those who conceived themselves to be officers and seemingly were de facto officers in succession to Gardner and O'Rourke, as the result of the transactions above stated concerning the acquisition by the former of the stock of Midland. As between the trustee in bankruptcy of Personal and this bank, the resolution is held to be valid, and the acceptance by the bank for deposit in the Northern account of the total sum of $11,382.91 is not subject to challenge in this litigation.

2. "Was a duty imposed on the bank to obtain the consent of the stockholders of the bankrupt in addition to the resolution of its Board of Directors?"

In view of the testimony and the somewhat equivocal provisions of statutory law of the State of New York touching this subject, the answer to this question is in the negative.

The following issues of fact are stated in the order:

1. "Was the bank negligent in accepting these checks for deposit in the light of the incomplete resolution dated November 21, 1956 which failed to set forth on the face of the instrument the holders of 100% of its issued stock and their consent to the authorizations contained therein?"

In the opinion of this court, the foregoing is to be answered in the negative.

2. "Was there a diversion of the bankrupt's funds brought about by the action of the bank in accepting the checks for deposit in the aforegoing manner?"

There is no proof to sustain an affirmative answer to the foregoing question; therefore, the answer is negative.

3. "Is the bank liable to the plaintiff for the proceeds of said checks by reason of subdivisions (1) and (2) of this paragraph?"

The answer to the foregoing is in the negative.

MICHIGAN SUPREME COURT UPHOLDS TAX ON BANK SHARES

The Supreme Court of Michigan has affirmed the State Court of Claims decision upholding the 5½ mill tax on bank shares in the state. Suit had been brought by the Michigan National Bank which was joined by five other banks. They took the position that the bank stock mill tax, enacted in 1953 as part of the Michigan intangibles tax law, was discriminatory in that it did not apply to savings and loan associations. The Supreme Court ruled however, that there was no discrimination because savings and loan associations in the State are markedly different in character purpose and organization from national banks.

United States Tax Liens Entitled to Priority After Mortgages and Ahead of Mechanics Liens

The Michigan Supreme Court was recently presented with a problem in circuitous priority of liens. First, second and third mortgagees of a defunct building corporation enjoyed priority under Section 6321 of the Internal Revenue Code over tax liens asserted by the United States and the lien of the United States for taxes enjoyed priority over certain mechanics liens. Under Michigan law, however, the mechanics liens had priority over the liens of the mortgagees.

The United States argued that since, under Michigan law, the mechanics liens took priority over the mortgage liens, its tax liens were entitled to priority over the mortgage liens because, under federal law, the tax liens were superior to the mechanics liens.

In effect the court agreed with the United States by decreeing that the proceeds of foreclosure be paid in the following order: first, to the mortgagees; second, to the United States tax liens; and third, to the mechanics liens, but if the proceeds be insufficient to pay the mechanics liens, the deficiency to be made up from the mortgagees.

The court stated that "This procedure affords to all parties the priorities to which they are entitled" and pointed out that if the proceeds are insufficient to pay everybody in full resulting in the United States being in part paid ahead of the mortgagees "such situation results from the paramount United States law." *River Rouge Savings Bank v. Victor Building Co.*, Supreme Court of Michigan, 101 N.W.2d 260. The opinion of the court follows:

KAVANAGH, J.—Sometime prior to 1956 the S & M Building Company, a Michigan corporation, was organized to engage in certain residential building projects. This company in connection with certain other building or construction companies, namely, Victor Building Company, Gilbert Construction Company and LeBlanc Construction Company—which were directly controlled and entirely owned by S & M Building

NOTE—For similar decisions see B. L. J. Digest (Fifth Edition) § 821.2.

Company—commenced a residential building project embracing some 75 homes in the city of Marysville, Michigan.

The appellees, Raymond Excavating Company and Kerr Lumber Company, were retained by the building companies, the former for excavating work and the latter for furnishing lumber and other construction materials.

As construction progressed on the residences, construction loans were obtained by the building companies from plaintiff River Rouge Savings Bank. These loans were evidenced by promissory notes secured by mortgage indentures, which were recorded by plaintiff mortgagee. Subsequently, default was made by the building companies in the payment of principal and interest on each of the promissory notes secured by the real estate mortgages. Upon default, plaintiff commenced its several actions in the St. Clair county circuit court for foreclosure of its mortgage security.

At this time title searches disclosed the presence of second and third mortgages, mechanics' lien claims and government tax liens. Therefore, plaintiff joined all such lien claimants as parties defendant in its bill of complaint.

Subsequently, both Kerr Lumber Company and Raymond Excavating Company filed cross bills to foreclose their respective mechanics' liens. Cross bills were also filed by the second mortgagees to forclose their mortgage liens.

Prior to the time plaintiff filed its bill of complaint, and beginning in February 1957, the United States government, through its district director of internal revenue, assessed sums against the S & M Building Company for withholding taxes and filed liens for such amounts. Upon demand for payment of the assessed taxes, the taxpayer, S & M Building Company, neglected and refused to pay the same or any part thereof.

On February 14, 1958, after plaintiff had filed its bill of complaint in the St. Clair county circuit court, the S & M Building Company and the other corporations under its control were named in a petition in involuntary bankruptcy, filed in the United States district court for the eastern district of Michigan, southern division. On February 28, 1958, a receiver in bankruptcy was duly appointed. The United States district court issued an order temporarily restraining plaintiff and cross plaintiffs from further proceedings in the circuit court. However, upon objections, the concurrent jurisdiction of the circuit court was recognized and the restraining order vacated. The parties were then permitted to proceed with the foreclosure of their respective liens in the circuit court.

The decision and decree of the lower court granted a priority to the mechanics' liens of Kerr Lumber Company and Raymond Excavating Company over the first mortgage lien of plaintiff, River Rouge Savings Bank. The court also ruled the government tax liens were subordinate to the mechanics' liens and the first and second mortgage liens, and fur-

ther that the government was only entitled to a 6-month period of redemption. Regarding attorney fees and costs, the court felt the issues raised presented legal questions not covered by Michigan precedent and, therefore, denied costs to all parties.

River Rouge Savings Bank has appealed, claiming the mechanics' liens claimed by Kerr Lumber Company and Raymond Excavating Company are invalid and, therefore, not entitled to priority over its first mortgage lien. The bank seeks confirmation of all other provisions of the lower court decree.

Both Kerr Lumber Company and Raymond Excavating Company have filed cross appeals claiming they are entitled to costs and allowances for reasonable attorney fees under applicable statutory provisions (C.L.1948, §§ 570.12, 570.21 [Stat.Ann. §§ 26.292, 26.301]). The cross appellants also claim the decree as to the claim of the United States should be reversed to allow the government tax liens to be prorated over the 19 lots in case No. 71-36 and accorded priority after the amount of the mortgages only and ahead of their respective mechanics' liens. The cross appellants seek affirmance of all other parts of the circuit court decree.

The United States has appealed, asking the decree of foreclosure, to the extent it awards priority to mechanics' liens over the United States tax liens, be vacated and remanded to circuit court with directions to award priority to the tax liens over the mechanics' liens. The United States further seeks correction of the decree to allow it 1 year from date of sale within which to redeem the mortgaged property.

On this appeal River Rouge Savings Bank claims the Raymond Excavating Company does not have a valid mechanics' lien because of failure by the company to make service of the sworn statement of contractor upon the building corporation owners as part of the statutory pre-condition to the filing of a valid mechanics' lien. The company conceded no sworn statement had been personally served upon the owners, because the company was unable to find the owners or their agents in the county after having made sufficient and repeated efforts to do so, thus fully complying with the statute. Testimony was introduced by the company which would tend to show the company had in fact, on repeated occasions, attempted to discover and serve such statement of contractor upon the owners in the county, but that all such attempts were fruitless since neither the owners nor their agents could be found.

River Rouge Savings Bank contends the Kerr Lumber Company is not entitled to a valid mechanics' lien because of the negotiation by the lumber company of the notes received by it from the various building corporation owners in amounts representing the materials furnished by the company to the owners. None of these notes was due within the time for Kerr Lumber Company to file claims of lien. These notes

were indorsed by the lumber company by blank indorsement and delivered to the Port Huron branch of the Michigan National Bank, at which time the company received cash or credit to its bank account for the value of the notes from the bank. While these notes were outstanding and while they were discounted at the Michigan National Bank, Kerr Lumber Company filed its claims of lien, notice of intention and sworn contractor's affidavit having been duly served. All statutory steps to perfect its liens were properly taken by the company. Some of the lots for which liens were originally served were in time paid off and waivers of lien were given by the company. However, no lien was discharged until the company had been paid in cash.

All the owner-builders' notes to Kerr Lumber Company, or their renewals, were past due and charged back to the company by the Michigan National Bank, and were in the company's possession prior to its filing its cross bills of foreclosure. All outstanding notes were tendered by the company to the court at the trial for cancellation upon receiving payment from the sale. If valid, there is no question that the Kerr Lumber Company mechanics' liens have priority over all mortgages in this case, since construction began before any mortgages were given or recorded (C.L.1948, § 570.9 [Stat.Ann. § 26.289]). The same is true as to the mechanics' liens of Raymond Excavating Company.

The appeal of the United States is based upon error claimed in the decree of the circuit court relative to the priority given the government tax liens. The lower court subordinated the tax liens to the mechanics' liens of Kerr Lumber Company and Raymond Excavating Company.

The Federal tax liens involved in this case arose under sections 6321, 6322 and 6323 of the Internal Revenue Code of 1954, 26 U.S.C.A. §§ 6321-6323. Section 6321 provides that if any person liable to pay any tax neglects or refuses to pay such tax after demand, the amount, including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto, shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such taxpayer. Section 6322 provides that unless another date is specifically fixed by law, the lien imposed by the above section shall arise at the time the assessment is made and shall continue until the liability for the amount so assessed is satisfied or becomes unenforceable by reason of lapse of time. Section 6323 provides, so far as material here, that the lien in favor of the United States imposed by section 6321 "shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed" as provided in subsection (a) thereof.

In this case, the district director of internal revenue assessed withholding and excise taxes against the S & M Building Company in February, May and September of 1957, which dates were subsequent to the execution and recording of the first and second mortgages on properties of

S & M Building Company. The United States does not contend its lien claims are superior to the claims of the mortgagees being secured by prior recorded mortgages.

The respective mechanics' liens, which were granted priority ahead of the government tax liens, arose and notices of intent and statements of claim of lien were duly recorded prior to the dates on which the Federal tax liens arose and were recorded.

The Federal tax lien provided by the above sections of the 1954 Internal Revenue Code, attaching as it does to all property and rights to property of the taxpayer as of the date of assessment, is valid against all subsequent claims or liens asserted against the taxpayer's property, except it is not valid as against any "mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed" as therein provided. The mechanics' lien claimants are not "mortgagees," "pledgees," "purchasers," or "judgment creditors" within the meaning of section 6323 of the 1954 code.

The mechanics' liens asserted by Kerr Lumber Company and Raymond Excavating Company were not choate, perfected liens at the time the Federal tax liens arose and were recorded. Upon this appeal, neither of the above mechanics' liens claimants assert any priority of their liens above those of the United States. In fact, both Kerr Lumber Company and Raymond Excavating Company admit the superiority of the government tax liens and ask reversal of the circuit court decree to the extent it awarded priority to their mechanics' liens over the tax liens.

Although the River Rouge Savings Bank does not deny the right of priority claimed by the United States over the mechanics' liens, the bank says the issue is now moot because of events subsequent to the circuit court decree. The United States contends the subsequent events involving orders of the bankruptcy referee do not moot the issues raised by the government, since the tax liens can only be extinguished by satisfaction of the assessed tax liability and the referee's orders failed either to determine or satisfy such liability.

The issue on appeal concerning Raymond Excavating Company involves the failure of the company, a contractor, to serve a sworn statement of contractor upon the owners prior to filing its affidavit and statement of lien. The applicable section of the mechanics' lien statute governing such service is C.L.1948, § 570.4 (Stat.Ann. § 26.284), which sets forth the requirements for delivering such sworn statement to the owner and provides penalties for failure to furnish such statement upon demand by the owner. The section further provides as follows:

> "If neither such owner, part owner, lessee, nor his agent can be found within the county, then it shall not be necessary for the contractor to make and deliver such statement as a prerequisite to the

institution of proceedings under this act, or other suit or proceeding."

The lower court found as a matter of fact that from the testimony it appeared the Raymond Excavating Company's official did endeavor to locate the owner in the county for the purpose of serving the sworn statement of contractor, and that his inability to do so did not deprive the company of a valid lien. While it is true the company, being unable to find the owners or their agents in the county, caused sworn statements to be mailed to the owners by registered mail, the return receipts indicating they had been received by the owners on the day following the filing of the statement and claim of lien, the lower court felt it was unnecessary to determine whether such actual notice alone would be sufficient.

From a review of the testimony it would appear the lower court properly determined a sufficient attempt had been made to locate the owners or their agents in the county. However, it would also seem that upon the receipt by the owners of the actual notice by registered mail, the lien would then attach even though such statement was not provided prior to filing the affidavit of lien. The statute, C.L.1948, § 570.4 (Stat.Ann. § 26.284), says that "until the statement provided for in this section is made, in manner and form as herein provided, the contractor shall have no right of action or lien against the owner, part owner, or lessee, on account of such contract . . . ." In Holliday v. Mathewson, 146 Mich. 336, 109 N.W. 669, the Court held that delay in serving upon the owner or his agents the statement required by statute until after the claim of lien had been filed was not fatal to the mechanics' lien where the statement is served before the time to file a lien expires. The Court held the lien would not become effective until the statement was served. The Court said (146 Mich. at page 338, 109 N.W. at page 670):

> "We are of the opinion that the delay in serving the statement is not fatal to the lien. No lien attached by the filing of the claim, but when the statement was served, the claim became effective. It is unimportant that the statement was served after the claim was filed. Both were done within the statutory period, and a lien was perfected on July 3d by the service of the statement. There is nothing in the various cases cited inconsistent with this holding."

It would appear that in the case at bar the lien of the Raymond Excavating Company would have become valid at the time the owner actually received the statement of contractor and the fact such statement was not received until after the affidavit of lien had been filed

would be inconsequential, since the lien would receive validity upon receipt of the statement, both accomplished within the statutory period for filing liens.

On the question of the right to costs and reasonable attorney fees of cross appellants Kerr Lumber Company and Raymond Excavating Company, the lower court felt the issues involved in this litigation were without precedent in Michigan, especially insofar as the issue involving the Kerr Lumber Company notes was concerned. Basing his opinion in this regard on the novelty of the legal questions involved, the court denied costs to either party. It is conceded that under the statutes (C.L.1948, §§ 570.12, 570.21 [Stat.Ann. §§ 26.292, 26.301]), the award of costs and attorney fees is discretionary. However, Kerr Lumber Company and Raymond Excavating Company claim the court abused its discretion, since they felt the issues were not without precedent. The cross appellants say the grounds for denial of costs and attorney fees are inequitable, since in effect all prevailing materialmen could be so barred in any litigation if those opposing the liens could discover any issue not precisely covered by past Michigan law. The case of Wisniewski v. Nawrocki, 153 Mich. 523, 116 N.W. 1065, held that although the applicable statutory provisions confide the question of costs and attorney fees in mechanics' lien cases to the court's discretion, the complainant in a bill to enforce a lien, on establishing his right to a decree, should be allowed his actual disbursements and a reasonable amount for his attorney. It would appear that under the authority of the Wisniewiski decision, the lower court should have awarded reasonable costs and attorney fees. Especially is this true in regard to the claim of the Raymond Excavating Company. Furthermore, it seems that although there is no Michigan authority directly in point on the issue of negotiation of the Kerr Lumber Company notes and the effect of such negotiation on the right to file mechanics' liens, there exists sufficient outside authority to decide that particular issue. Since no other reason was advanced by the lower court for its denial of costs and attorney fees than the question of novelty, and since this reason appears without actual merit, an award for costs and reasonable attorney fees should be awarded to Kerr Lumber Company and Raymond Excavating Company as prevailing parties.

On the issue whether the United States is entitled to a 6-month or 1-year period for redemption, it appears the lower court was wrong in merely allowing the shorter period. It is clear the United States was made a party to this State court mortgage foreclosure proceeding pursuant to 28 U.S.C. § 2410. Section 2410(c) reads in part as follows:

> "A judicial sale in such action or suit shall have the same effect respecting the discharge of the property from liens and encumbrances held by the United States as may be provided with

respect to such matters by the local law of the place where the property is situated. . . . Where a sale of real estate is made to satisfy a lien prior to that of the United States, the United States shall have one year from the date of sale within which to redeem."

Direct authority against the decree of the lower court granting merely a 6-month redemption period is the case of United States v. Bank of America National Trust & Savings Association, 9 Cir., 265 F.2d 862. The court held that compliance with the subsection of the statute requiring a judicial proceeding in which the government may assert its lien, and its right of redemption within 1 year from the date of a lien foreclosure sale, is a condition of the government's consent to be sued in a civil action in any State court for foreclosure of a mortgage or other lien upon realty or personalty on which the United States has or claims a mortgage or other lien. The court said (at page 868):

"In our opinion a compliance with subsection '(c)' is a condition of the Government's consent to be sued under Section 2410. Subsection (c) requires (1) a judicial proceeding in which the Government may assert its lien; and (2) the right of redemption within one year from the date of sale. Many states do not provide any period of redemption, so that regardless of the method of foreclosure, the Government often has a right not available to private lien holders. This is an express condition of the Government's consent to be sued."

On petition for rehearing, the court wrote as follows (at page 869):

"In enacting Section 2410, Congress did more that simply provide for waiver of immunity from suit. It imposed a condition for divestiture of the property rights of the United States, i. e., a period of redemption from the foreclosure sale. If Section 2410(c) is limited to foreclosure by action, followed by a judicial sale, then a Government lien could be extinguished, without notice and without right of redemption, where the mortgagee proceeded under a power of sale; whereas, in foreclosure by action, the Government would have a right of redemption, regardless of state law,—a wholly illogical result in those states, for example, which do not provide any right of redemption. In our opinion, a compliance with subsection (c) is a condition of the Government's consent to be sued in any foreclosure under Section 2410. This requires a judicial proceeding in which the Government may assert its lien and the right of redemption within one year from the date of sale."

The United States says it does not have any present intention of

exercising its right to redemption in this case, but has appealed this part of the circuit court's foreclosure decree to escape any contention that by failing to appeal from that part of the decree the United States had waived its 1-year right of redemption. Thus, the United States wishes the decree to be corrected to allow the United States 1 year from the date of sale within which to redeem the mortgaged property.

On the issue of priority of the tax liens of the United States, it is clear the finding and decree of the circuit court is erroneous and must be corrected. The United States claims that Federal tax liens arising under sections 6321 and 6322 of the 1954 Internal Revenue Code, notices of which were duly filed in accordance with section 6323(a) of the 1954 code, are entitled to priority in payment of proceeds derived from a foreclosure sale of mortgaged property of the delinquent taxpayer ahead of earlier unperfected mechanics' liens asserted under Michigan law against such property. It is to be noted that both of the mechanics' lien claimants—Kerr Lumber Company and Raymond Excavating Company—agree with the position of the United States and admit that such government tax liens are superior to and entitled to priority ahead of their respective mechanics' liens. Even the River Rouge Savings Bank fails to deny the priority of the United States' lien, but claims the issue is moot because of events subsequent to the circuit court's decree whereby proceedings before a referee in bankruptcy in Federal court have in effect dissolved any lien held by the United States. The United States disputes this claim, pointing out the following facts: An involuntary petition in bankruptcy was filed against the owner-taxpayer in Federal district court subsequent to the time this action was begun in circuit court. The concurrent jurisdiction of the latter court to adjudicate the issues here involved was established. The circuit court established valid liens for unpaid taxes in favor of the United States against the S & M Building Company, the principal corporation which entirely owned and controlled all the construction or building firms against which claims were being pressed. The validity of such Federal tax liens is not in issue. The government admits the tax liens are inferior to the River Rouge Savings Bank mortgage liens but since, under Michigan law, the mechanics' liens of Raymond Excavating Company and Kerr Lumber Company take priority over the bank's mortgage liens in the situation involved in this case, and the circuit court so found, the government contends its tax liens are in effect entitled to priority over the mortgage liens as, under Federal law, the tax liens are superior to the mechanics' liens. The United States says the issue of priority of its tax liens was not determined by the bankruptcy referee and thus neither this issue nor the one involving the period of redemption are rendered moot by the action of the referee. The United States alleges that under the applicable sections of the Internal Revenue Code of 1954 the tax lien constitutes a general lien upon all property and rights

to property, real or personal, belonging to the delinquent taxpayer, and further that such lien attaches at the time the tax assessments are made and continues until the liability for the assessed amount is satisfied or becomes unenforceable through lapse of time. The United States says the referee's orders do not constitute a satisfaction of the tax liability and that the referee failed to have full jurisdiction over all the property of the delinquent taxpayer.

It would appear the order of the referee failed to resolve the issue of priority or the validity or amount of the government liens. The referee's order merely said that with sale of the property of S & M Building Company (for $37,500) the liens, if any, of the Federal government and the State of Michigan are transferred to such proceeds and are assumed by the offerors. The referee's order, therefore, does not moot the issues involved in this appeal by the Federal government as it would seem the issues of priority and period of redemption should be decided. The question of priority of the Federal tax liens over the earlier unperfected mechanics' liens of Kerr Lumber Company and Raymond Excavating Company is fully answered by United States v. Security Trust & Sav. Bank, 340 U.S. 47, 71 S.Ct. 111, 95 L.Ed. 53, and other cases in footnote.[1] Neither the mortgagee, River Rouge Savings Bank, nor the mechanics' lien holders, Kerr Lumber Company and Raymond Excavating Company, dispute the priority of the Federal tax liens over the mechanics' liens.

On the issue of the validity of the mechanics' lien of Kerr Lumber Company, the question as framed by appellee Kerr Lumber Company seems preferable to that of appellant bank. Thus the lumber company asks: Where a materialman accepts notes from the owners as evidence of debt for material furnished in construction, which notes were not due within the time for filing statement and claim of mechanics' liens, and which notes were discounted by blank indorsement to a bank prior to the materialman's filing such claim of lien, but which notes and renewals thereof were past due and in materialman's possession prior to its filing bills of foreclosure, has a waiver of the materialman's lien

[1] United States v. Gilbert Associates, 345 U.S. 361, 73 S.Ct. 701, 97 L.Ed. 1071, reversing 97 N.H. 411, 90 A.2d 499; United States v. City of New Britain, Conn., 347 U.S. 81, 74 S.Ct. 367, 98 L.Ed. 520, reversing Brown v. General Laundry Service, 139 Conn. 363, 94 A.2d 10; United States v. Acri, 348 U.S. 211, 75 S.Ct. 239, 99 L.Ed. 264, reversing 6 Cir., 209 F.2d 258; United States v. Liverpool & London & Globe Ins. Co., 348 U.S. 215, 75 S.Ct. 247, 99 L.Ed. 268, reversing 5 Cir., 209 F.2d 684; United States v. Scovil, 348 U.S. 218, 75 S.Ct. 244, 99 L.Ed. 271, reversing 224 S.C. 233, 78 S.E.2d 277; United States v. Colotta, 350 U.S. 808, 76 S.Ct. 82, 100 L.Ed. 725, reversing, per curiam, 224 Miss. 33, 79 So.2d 474; United States v. White Bear Brewing Co., Inc., 350 U.S. 1010, 76 S.Ct. 646, 100 L.Ed. 871, reversing, per curiam, 7 Cir., 227 F.2d 359; United States v. Vorreiter, 355 U.S. 15, 78 S.Ct. 19, 2 L.Ed.2d 23, reversing per curiam, 134 Colo. 543, 307 P.2d 475; United States v. Hulley, 358 U.S. 66, 79 S.Ct. 117, 3 L.Ed.2d 106, reversing, per curiam, Fla., 102 So.2d 599.

right occurred? No Michigan decision appears to be directly in answer to this issue; however, there are Michigan decisions involving other than mechanics' liens which are somewhat analogous to the facts of this case.

It is clear the mere acceptance of the notes by Kerr Lumber Company as evidence of the debt, which notes were not due within the time for filing the liens, did not prevent the lien from attaching when the claim was duly filed by the Kerr Lumber Company. The cases of Marquette Lumber Co. v. Albee, 196 Mich. 127, 162 N.W. 1005; Smalley v. Ashland Brown-Stone Co., 114 Mich. 104, 72 N.W. 29, and Knowlton v. Gibbons, 210 Mich. 547, 178 N.W. 63, may be cited in support of this statement.

On the issue of whether the discounting of the notes at a bank by Kerr Lumber Company constituted a waiver of its lien rights where the notes were due and back in the claimant's possession prior to enforcing its liens by foreclosure, we must rely on authority from jurisdictions other than Michigan, since there seems to be no Michigan decision directly on this issue involving mechanics' liens.

The following general rule is stated in 57 C.J.S. Mechanics' Liens § 226, p. 800:

> "The transfer or negotiation of notes taken by claimant does not defeat his right to a lien, at least where the note is indorsed back to, or taken up by, claimant so that it is in his possession and control at the commencement of the suit and he surrenders it in court at the hearing."

To the same effect, see 18 RCL 970 and 65 A.L.R. 294, the latter saying as follows:

> "The general rule as to the effect of the claimant's negotiating a note accepted by him from the owner or the contractor seems to be that such negotiation, of itself, will not constitute a waiver of the right to enforce a mechanics' lien."

In Hill v. Alliance Building Co., 6 S.D. 160, 60 N.W. 752, it was held a materialman who liquidates the amount of his claim by taking the owner's note and transfers it to another by his blank indorsement, thus binding him to pay the note if the maker fails, still retains an interest in the note which entitles him to file a valid mechanics' lien within the statutory period in his own name. The court there said (6 S.D. at pages 171, 172, 60 N.W. at page 755):

> "In our opinion, the filing of the lien within the statutory time limit, by the parties for the benefit of whom the lien was created,

and at a time when their interests required the full protection of the law enacted for their benefit, was a substantial compliance with the requirements of the statute as to notice; and the fact that the note had been, a few days prior thereto, conditionally disposed of, or transferred by an indorsement binding them to pay if the debtor failed, is of no concern to the owner of the property charged with the lien, or to his successors or assigns. The transfer of the note did not relieve Fraser & Shepherd from paying W. S. Hill & Co. for the material by which the value of the premises in controversy was largely created, as they were liable upon their indorsement if the maker failed to pay the note at maturity. Neither did such transfer release the Alliance Building Company from liability to Fraser & Shepherd upon the original contract, so long as the note remained unpaid; and to say that a materialman, in a case like the present, by assigning his claim, waives his rights, and is precluded from filing an available lien for the protection of himself and his assignee, would be to hold that our mechanic's lien law is not sufficient to provide effectual security to those who, by their labor, skill, and material, have created or enhanced the value of the property, which ought to stand as security until the debt is paid. There are no good reasons for saying that the lien is lost, or that it cannot be enforced by an assignee who has brought the note into court, and offered the same for cancellation. We therefore hold that the negotiation of the note neither defeated nor suspended the right of the claimants and payees therein named to file their lien, and make it available to their assignee or themselves in case they had been called upon to take up the note and enforce the collection of their claim against the Alliance Building Company."

Another case in support of the proposition that a mechanics' lien holder retains such interest in the note after negotiation to enforce a lien is German Bank v. Schloth, 59 Iowa 316, 13 N.W. 314. In the German Bank case the court stated (59 Iowa at pages 322, 323, 13 N.W. at page 317):

"Can the lien-holder, the payee of the note, after he has received the note from the indorsee, enforce the lien? We think he can, for these reasons. He at no time was without interest in the note. He was responsible while it was in the hands of the indorsee as an indorser, and that responsibility was accompanied by the liability of the maker to him. The contract of the indorser and maker run together. The indorser agrees to pay if the maker does not; and the maker is bound to the indorser if he fails to pay the indorsee. These are subsisting contracts while

the paper is in the hands of the indorsee. Like all other contracts they are only enforceable by action upon default by the parties bound. The maker, all the time the note is in the hands of the indorsee is bound by this contract to the payee. We conclude, therefore, that the payee does not cease to become a party to the contract so as to waive any liens which accompany the note."

In the case of Standard Oil Company v. Sowden, 55 Ohio St. 332, 45 N.E. 320, a fact situation similar to that in the case at bar was presented. In that case the contractors, upon completion of certain oil tanks in an oil company refinery, took 3 notes from the owner for the balance due. These notes were then indorsed and sold to a bank. Within 4 months after completion of the structure and while the bank was the owner and holder of the notes, the contractors made and filed an affidavit in due form for perfecting a mechanics' lien to secure the indebtedness for erecting the structure. The court held the contractors had a valid mechanics' lien.

In McLean v. Wiley, 176 Mass. 233, 57 N.E. 347, the mechanics' lien claimant received notes under an agreement they were not taken in payment of the debt. When the claimant filed his statement of lien some of the notes were in the hands of third parties; however, they were taken up by the claimant before enforcement proceedings were begun. The supreme judicial court of Massachusetts, speaking through Chief Justice Holmes, held the trial judge properly refused to rule that the claimant could not maintain a lien for the portion of the account included in the outstanding notes. See also, National Surety Company v. Price, 162 Ky. 632, 172 S.W. 1072.

While Michigan has not ruled on the effect of negotiation of notes prior to filing claim of lien in cases involving mechanics' liens, there have been rulings involving common-law sawyers' liens and statutory watercraft liens.

In McEwan Bros. & Co. v. Carpenter, 111 Mich. 522, 69 N.W. 1117, the Court held that evidence the owner of logs gave his notes for the saw bill and that the sawyers discounted the notes, and protected them in the hands of the holders by collateral security, is insufficient of itself to establish a waiver of the lien for sawing.

In the case of Sarmiento v. The Catherine C., 110 Mich. 120, 67 N.W. 1085, the mechanics' lien claimant had a contract with defendant for certain labor on a boat. The contract provided for periodic payments as the work progressed. Defendant sent the claimant a first payment note, which the claimant credited on defendant's account. The note was renewed when it matured and both the original and renewal notes were discounted by the claimant. Subsequently, claimant filed his complaint seeking a lien. The note was not redeemed by claimant

until before judgment. Defendant contended claimant's acts constituted a waiver of the lien, but the court rejected this contention.

In the instant case it is apparent that no waiver of the lien on the part of Kerr Lumber Company existed either by agreement or by taking the notes. This procedure is a very usual one and necessary to carrying on everyday business relationships. Contractors need credit; so do suppliers. In order to supply construction materials suppliers have to purchase these materials. They are able to do this in the ordinary business world by discounting notes obtained from purchasers, providing the necessary life blood to permit the carrying on of our complex business system. They are required to pay them in the event the maker defaults. Certainly, it was the intent of the legislature under the mechanics' lien law to permit them to file the statement so that they might protect themselves in the event of the maker's default. Default did occur in this case. Kerr Lumber Company, lien claimant, was required to pay the notes at the bank and had them available in court for discharge in the event payment was tendered. More they could not and should not be required to do. If our law was otherwise, business and credit under these circumstances would come to a complete standstill. An interpretation that would permit this to happen cannot be read into the mechanics' lien law.

On the question of the proper distribution procedure herein involved, the case of Samms v. Chicago Title & Trust Co., 349 Ill.App. 413, 111 N.E.2d 172, seems pertinent. In that case the court said (349 Ill.App. at page 422, 111 N.E.2d at page 176):

> "It is our conclusion that the claim of the mechanic's lien holder in this case is not within the meaning of Section 3672 and is subordinate to the lien of the government's tax claim. This priority of the government's lien, if only the mechanic's lien were here involved, would be full and complete as to all proceeds derived from the sale of the property resorted to. However, where, as in this case, there is a mortgage which is a lien prior to that of the government's tax claim, then the government for satisfaction of its lien can only resort to those proceeds from the sale of the property which are in excess of the mortgage indebtedness. Therefore, the priority of the government's lien in the instant case is only as to that excess. The mechanic's lien claimant by state law is given a lien prior to that of the mortgagee, which in effect means that it may resort to the proceeds from the sale of the property which are applicable to payment of the mortgage indebtedness. This is the inevitable result of the application of the Act of Congress and of the state law."

Thus the decree, paragraph 30, should provide that the sale proceeds after expenses of sale be paid in the following order:

(1) To the mortgagees, in order of their priority.

(2) To the United States tax liens, prorated to respective lots of case 71-36.

(3) To the mechanics' liens, but if proceeds be insufficient to pay them, the deficiency to be made up from the mortgagees, in reverse order of the mortgagees' priority.

(4) To restore to the mortgagees any such deficiency paid to mechanics' liens.

(5) To the owners.

This procedure accords to all parties the priorities to which they are entitled. If, as a matter of fact, the proceeds are insufficient to pay all liens, resulting in the United States being in part paid ahead of the mortgagees, such situation results from the paramount United States law under which the mortgagees claim their priority over United States tax liens, in time of recording. This priority is thus qualified by the same United States law to the extent its lien displaces mechanics' liens prior to mortgages under local law.

On the other hand, the State law of Michigan accords mechanics' liens priority over mortgages recorded after construction was begun, as in the instant case.

Therefore, as to the appeal of the appellant bank, the decree sustaining the validity and amount of the mechanics' liens of Kerr Lumber Company and Raymond Excavating Company, and the priority of such liens over the mortgages, is affirmed.

As to the cross appeal of Kerr Lumber Company and Raymond Excavating Company, the decree is reversed as to disallowance of costs and attorney fees and modified to award to such cross appellants their actual filing and recording fees, taxable court costs and reasonable attorney fees in the lower court, to be determined by the lower court.

As to the appeal of the United States, the decree is reversed to allow priority to such tax liens after the amount of the mortgages only and ahead of the mechanics' liens and the United States is entitled to a period of 1 year from the date of sale within which to redeem the mortgaged property.

Cross appellants Kerr Lumber Company and Raymond Excavating Company shall have costs of this Court.

DETHMERS, C. J., and CARR, KELLY, SMITH, BLACK and EDWARDS, JJ., concur.

SOURIS, J., took no part in this decision.

Endorsement of Checks Payable to Fictitious Persons Constitutes Forgery

In *United States v. Bank of America,* United States Court of Appeals, Ninth Circuit—F. 2d—which is discussed at page 223 of the March 1960 issue of THE BANKING LAW JOURNAL, the U.S. Treasury was not permitted to hold a bank liable for cashing tax refund checks issued pursuant to fraudulent refund claims. In so holding the court applied the so-called "impostor rule" applicable to checks made payable to fictitious persons.

The United States Circuit Court of Appeals for the Tenth Circuit was recently faced in a criminal prosecution for forgery with an almost identical factual situation. The accused filed a number of income tax returns and requests for refunds based upon attached W-2 forms. The returns bore fictitious names and addresses and when the refund checks were received by the accused they were endorsed and cashed by him.

In the *Bank of America* case the Ninth Circuit concluded that the government agents who issued the checks intended to deal in each instance with the person who wrote his name on the false tax return and hence when that person endorsed his name on the checks there had been no forgery. The Tenth Circuit, on the other hand, concluded that such an endorsement constituted the crime of forgery. Presumably the Tenth Circuit would also hold the cashing banks civilly liable to the United States for cashing forged paper. *Kitchens v. United States,* United States Court of Appeals, Tenth Circuit, 272 F.2d 757. The relevant part of the court's opinion is as follows:

PICKETT, C.J.—Mack Kitchens, Jr., and his wife Betty, were convicted on separate indictments charging them with filing false claims against the United States, forging and uttering United States Treasury checks, and conspiring to commit the foregoing offenses.

Mack Kitchens, Jr., appeals from judgments and sentences which total 15 years confinement.[1] The principal questions presented here, on a

[1] Kitchens was sentenced to 5 years imprisonment on one count charging the

NOTE—For similar decisions see B. L. J. Digest (Fifth Edition) § 587.

consolidated record, arise out of his defense of insanity.

The charges grew out of a rather elaborate and far-flung scheme to obtain refund checks from the Department of Internal Revenue. The scheme included the preparation and filing of income tax returns on regular 1040 forms and the request for refunds based on attached W-2 forms showing amounts withheld by employers in excess of the tax due on earnings from such employment. A large number of such returns bearing fictitious names and addresses were filed by Kitchens and his wife, including seven that were found to have been filed in the State of Wyoming. When the refund checks were received by Kitchens or his wife through the mail, they were endorsed—usually by Kitchens—and cashed.

It is urged that the endorsement of the United States Treasury checks issued to a fictitious person does not constitute forgery. The law is to the contrary. In Buckner v. Hudspeth, 10 Cir., 105 F.2d 393, 395, this court said:

> "Furthermore, to constitute forgery the name alleged to be forged need not be that of any person in existence. It may be wholly fictitious if the instrument is made with the intent to defraud and shows on its face that it has sufficient efficacy to enable it to be used to the injury of another."

See also Rowley v. United States, 8 Cir., 191 F.2d 949; Milton v. United States, 71 U.S.App.D.C. 394, 110 F.2d 556.

Other assignments of error, including the sufficiency of the evidence to sustain the conspiracy indictment, have been considered and found to be wholly without merit.

Affirmed.

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offense of filing false claims against the United States, and 10 years on one count charging forgery. Sentences on all other counts were to run concurrently, either with the 5 year sentence or the 10 year sentence.

STATE COURT APPROVES SHORT TERM BANK LOANS TO SCHOOL DISTRICTS

The Wisconsin Supreme Court has recently handed down a decision indicating approval of short-term bank loans to school districts which have need of operating funds. Under this ruling school districts may borrow Bank funds and pledge as security the tax receipts to be transmitted to them by the state later in the year.

FEDERAL BANKING LAWS

By F. GLOYD AWALT of the Washington, D. C. Bar

Notes from Washington pertaining to federal banking legislation and the regulation of banks by supervisory agencies.

Legislation

A Conference Report has been issued on H. R. 8684, a bill dealing with the income tax treatment of certain dealers' reserves (see THE BANKING LAW JOURNAL for September, 1959). The bill seeks to amend the Internal Revenue Code to provide for deferral of taxation of amounts withheld by a bank or finance company from a dealer in personal property to secure obligations of the dealer, until such time as such amounts are paid to or made available to the dealer. As agreed to by the Conferees, the bill would: (1) apply to a taxpayer who was required to compute his taxable income under an accrual method for his most recent taxable year ending on or before June 22, 1959, even though he may have originally computed his taxable income for such year under some other method; (2) extends to September 1, 1960, the date by which a taxpayer who is eligible for the tax treatment afforded by the bill may make an election under section 3(a) or 4(a); (3) provides that an election under either of these sections will apply to taxable years with respect to which the period of limitations had not expired on June 21, 1959, even though the period may have expired after that date and before the date of the election; (4) adds a new subsection which provides for an extension of the period of limitations for assessment, refund, or credit in the case of taxpayers who make an election under either section 3(a) or 4(a); (5) provides that if the net increase in tax (as defined in the bill) which results solely from the effect of an election under section 4(a) of the bill exceeds $2,500, the taxpayer may elect to pay any portion of such net increase which is unpaid on the date of the election in 2 or more, but not to exceed 10, annual installments; (6) specifies that the privilege of paying in installments shall terminate, and the unpaid installments become payable on notice and demand, in the case of an

individual or corporation, if the taxpayer ceases to engage in any trade or business, or in the case of a taxpayer who is a partner, if the partnership terminates; and (7) adds to the definition of dealer reserve income that part of the consideration derived by a dealer from the sale of real or tangible personal property in cases where the financial institution provides part or all of the consideration derived by a dealer from the finance charges connected with the financing of such sale, which is held in a reserve account by the financial institution which financed the sale.

The House Committee on Post Office and Civil Service has favorably reported H. R. 9507, concerning the waiver of collections by the Postmaster General on certain raised money orders. The bill would permit the Postmaster General, at his discretion, to waive collection on raised money orders cashed by banks, business concerns, and individuals where there is no evidence of alteration of the document to put the cashier on notice.

The House Committee on Post Office and Civil Service has also favorably reported H. R. 10996, a bill to authorize the use of certified mail for the transmission or service of matter required by certain federal laws to be transmitted or served by registered mail. If enacted into law, the bill would permit national banks to give notice to its shareholders of the issuance of preferred stock, amendment of its articles of association or conversion into and merger or consolidation with a state bank either by registered mail or certified mail.

Federal Reserve System

Credit by Brokers, Dealers, and Members of National Securities Exchanges. The Board is considering an amendment to paragraph (d) of § 220.4 of Part 220, concerning the extension of credit for the purpose of effecting arbitrage transactions, and a conforming amendment to subparagraph (3) of paragraph (d) of § 220.3. In order to clarify the Board's position in this matter and provide more explicit standards in the application of these provisions, it is proposed to substitute a 90-day period for the present "reasonable time" standard.

Loans by Banks for the Purpose of Purchasing or Carrying Registered Stocks. The Board is also considering an amendment to paragraph (j) of § 221.2 of Part 221 concerning the extension of credit by banks for the purpose of effecting arbitrage transactions. The purpose of the proposed amendment is to define the term "arbitrage." Under the proposed amendment "arbitrage" is defined as being: (1) a purchase or sale of a security in one market together with an offsetting sale or purchase of the same security in a different market at as nearly the same time as practicable, for the purpose of taking advantage of a difference in prices in the two markets, or (2) a purchase of a security which is, without restriction other than the payment of money, exchangeable or convertible within 90 calendar days following the date of its purchase into a second security together with an offsetting sale at or about the same time of such second security, for the purpose of taking advantage of a disparity in the prices of the two securities.

Director Serving Member Bank and Closed-end Investment Company Being Organized. The Board has recently expressed the opinion that it believes that Section 32 of the Banking Act of 1933 is applicable to a director of a member bank serving as a director of a closed-end company which is in the process of organization and is actively engaged in issuing and selling its shares, and that the section would be applicable while this activity continued.

Payment of Interest on Deposits. Paragraph (d) of § 217.3 provides that a member bank may pay interest on a savings deposit received during the first 10 calendar days of any calendar month at the applicable maximum rate prescribed by the Regulation from the first day of such calendar month until such deposit is withdrawn or ceases to constitute a savings deposit, whichever shall first occur. The Board has now been asked to clarify the following situations:

(1) Mail deposits postmarked the 10th or earlier: It is the Board's opinion that the postmark does not determine when the deposit is delivered to the bank. The customer adopts the post office as his agent and, therefore, must rely upon such agent making the deposit within the first 10 calendar days.

(2) Deposits received in the "drop box" located in the bank lobby and opened the morning of the 11th: Deposit in the drop box during the first 10 calendar days amounts to receipt by the bank and the day the bank opens the drop box does not change this.

(3) Deposits received in the night depository and opened the morning of the 11th: The same conclusion as for (2) above.

(4) Collections outstanding until the 11th or subsequent date: Items received for collection on or before the 10th calendar day may be included although final credit is not given until after the 10th day.

(5) Auto bank deposits not received in the savings department until the morning of the 11th: If the deposit is delivered to the bank, branch, or any office thereof by the 10th calendar days, interest may be credited from the 1st day of the month regardless of when the item is processed and credit is given.

(6) Transfers from branches received at the Main Office on the 11th: Same conclusion as (5) above.

(7) Inter-department credits held over until the 11th due to late hour business: Same conclusion as (5) above.

Credit by Brokers, Dealers and Members of National Securities Exchanges. In order to eliminate possible ambiguities and to make clearer what situations are covered by paragraph (d) of § 220.6 of Part 220, relating to the transfer of general accounts between customers, the Board is considering amending this section by adding at the end thereof examples of successions covered by this section, such as: Trustees in bankruptcy and receiver, in place of bankrupts and other insolvents; executors, administrators, and beneficiaries in place of decedents; successor trustees or other fiduciaries, in place of their predecessors; beneficiaries, in place of trustees or other fiduciaries.

Loans by Banks for the Purpose of Purchasing or Carrying Registered Stocks. The Board proposes to make a conforming amendment to paragraph (3) of § 221.3 of Part 221, relating to the transfer of loans between borowers, by adding at the end thereof the same examples of successions covered as given for paragraph (d) of § 220.6 of Part 220 above.

BANKING BRIEFS

Digest of current decisions and reports in the field of commercial banking

Collateral Security Covers Subsequent Indebtedness

McGilly v. Day Trust Company, Supreme Judicial Court of Massachusetts, 164 N. E. 2d 334

Borrower was obligated to bank in amount of $24,000 and gave note which bore figures $24,000 but in words recited promise to pay "Twenty Thousand Dollars." Right of bank in collateral deposited to secure loan and any liability "which may hereafter arise . . . whether then payable or not" survived borrower's death and proceeds of collateral could be used to liquidate note (regarding it as a note in amount of $20,000 since written words control) plus remaining $4,000. *For similar decisions see B.L.J. Digest* (Fifth Edition) § 1272.

Material Alteration Voids Promissory Note

Smith v. Hough, Supreme Court of Iowa, 100 N.W. 2d 906

Defendant borrowed $2,500 from plaintiff and made and delivered note for that amount to plaintiff. Plaintiff allegedly loaned an additional $500 to defendant and, without defendant's knowledge or consent, added above signature of defendant on note "Five Hundred Dollars added plus interest from September 30, 1956." Although plaintiff believed she had right to do what she did, court held note was materially altered and therefore void and plaintiff could neither recover on note as altered nor as to its original tenor. *For similar decisions see B.L.J. Digest* (Fifth Edition) § 63.

Repayment of Debt to Bank Not a Voidable Transfer

Mayo v. Pioneer Bank & Trust Company, United States Court of Appeals, Fifth Circuit, 274 F. 2d 320

Bankrupt borrowed $10,000 from bank and deposited $9,000 of the proceeds of that loan in an account of another corporation in same bank which was overdrawn in the amount of $4,398.69. In action brought by trustee in bankruptcy of borrowing corporation to recover $9,000, the court, on petition for rehearing, reaffirmed earlier holding that bank furnished fair consideration and transfer not voidable under Section 67 of Bankruptcy Act even as to the $4,398.69 paid to the bank to cover overdraft of the other corporation where the latter corporation and bankrupt were really one and the same. Bank, furthermore, was only a conduit through which money passed and, as to common law liability, bank enjoyed protection of Section 9 of Uniform Fiduciaries Act. *For similar decisions see B.L.J. Digest* (Fifth Edition) § 144.

Bank Charged With Knowledge of Dishonest Officer

Commercial State Bank v. Algeo, Court of Civil Appeals of Texas, 331 S.W. 2d 84

A trustee maintained a trust account in a bank of which he was an officer and where he maintained his personal account. When the trustee withdrew trust funds, deposited them in his personal account and then paid his personal debt to bank out of the commingled funds in his personal account, the court held that the bank had actual knowledge of the trustee's breach of trust because the trustee, as an officer of the bank, also acted as representative of the bank. *For similar decisions see B.L.J. Digest* (Fifth Edition) § 1132.

Drawee Bank Not Liable to Holder in Due Course

South Chicago Savings Bank v. Drexel National Bank, Appellate Court of Illinois, First District, Second Division, 164 N.E. 2d 503

Where plaintiff, holder in due course of check on which payment had been stopped, sued drawee bank, court reversed judgment for plaintiff stating that under Negotiable Instruments Law a check is not an assignment and that a different rule for holders in due course would not be feasible because it would be impossible for commercial banks, at their risk, to determine whether holder is holder in due course. *For similar decisions see B.L.J. Digest* (Fifth Edition) § 281.

Application for Bank Charter Approved

Application of Millburn-Short Hills Bank, Superior Court of New Jersey, Appellate Division, 158 A 2d 66

Substantial evidence supported finding of New Jersey Commissioner of Banking and Insurance that applicant for new bank charter met burden of establishing that interest of public would be served by establishment of proposed bank and that conditions afforded reasonable promise of successful operation. *For similar decisions see B.L.J. Digest* (Fifth Edition) § 121.

Fine Print on Reverse Side of Credit Card Binding

Union Oil Company of California v. Lull, Supreme Court of Oregon, 349 P. 2d 245

In action against defendant to recover value of goods sold and delivered to person who had stolen defendant's credit card, defendant bound by provisions in fine print on reverse side of credit card whereby defendant guaranteed payment to plaintiff-issuer of card of all purchases until card surrendered or notice received that it was lost or stolen. Plaintiff-issuer, as indemnitee, by analogy to duty of banks in comparable situations, must make reasonable inquiry as to authority of person presenting card. *For similar decisions see B.L.J. Digest* (Fifth Edition) § 359.

BANKING LEGISLATIVE TRENDS IN THE STATES

New legislative and regulatory developments affecting small loan and finance companies, credit insurance, banking and related fields, as reported from state capitals and municipalities throughout the nation, include the following:

ALABAMA: A number of small loan companies face the loss of their licenses for violation of rules promulgated under Alabama's new small loan law, according to State Supervisor of Loans Lehman J. Lewis, who said his office was delaying the crackdown until the license renewal deadline July 5.

Lewis said several loan companies were violating regulations that forbid a loan company operator from making more than one loan to any person at one time; forbid a loan company operator from knowingly permitting a borrower to obtain a loan from more than one company operated by a single businessman; and forbid a loan licensee from requiring a borrower to pay notary fees.

Lewis noted that the newly created Alabama Bureau of Small Loans had been partially stymied in enforcing these regulations by an injunction suit at Mobile. A similar suit for an injunction embracing the regulations was recently dismissed by Montgomery Circuit Court Judge Walter B. Jones.

ALASKA: A bill to regulate the sale of credit life and accident and health insurance was introduced in the Alaska legislature.

Listed as House Bill 307, the measure provides rules relating to the sale of credit covers on all loans and credit transactions of less than five years' duration.

The proposal stipulates acceptable policy forms for filing with the state insurance commissioner for approval.

CALIFORNIA: Criticism of the credit card system was expressed in a brochure issued by California State Consumer Counsel Helen Ewing Nelson.

"Remember," the brochure cautioned, "it's smart to shop for credit. It's even smarter—and cheaper, too—to pay cash."

Mrs. Nelson also called the use of credit the "number one consumer problem in California."

The brochure included a message signed by Governor Brown, who originated the consumer counsel post for California when he appointed Mrs. Nelson to the position six months ago. Brown noted that "credit

cards, bank cards, revolving charge accounts and many other inducements to buy now and use credit to defer payment" had been added to traditional installment and regular charge account buying.

"Our high standard of living," he said, "can be attributed in large part to willingness by business to risk immediate profit in return for long-range gains. But credit can be dangerous if it causes us to over-extend ourselves, to buy without knowing what the cost of credit adds to the quoted price of a product."

Mrs. Nelson said most consumers were more concerned with their monthly payment for a purchase than with the difference between the cash price and the credit price.

The brochure listed various percentages to show "what you pay for credit if added to purchase price and total repaid in 12 equal monthly payments." For example, it said "when they said 4 per cent per year, you pay 7.3 per cent," and "when they say 6 per cent per year you pay 10.9 per cent."

In another development, the California legislature passed and sent to the governor bills designed to curb operations of so-called "10 per centers" in second trust deeds.

One bill, listed as AB 84 by Hanna, would require real property brokers to give purchasers a legal description of the property subject to the trust deed or mortgage and disclose details of all prior encumbrances on the property.

It would also make it a misdemeanor to encumber property beyond 100 per cent of its value, and require that money obtained in advance from investors be held in escrow and when second trust deed paper is acquired for a client that it be recorded in the client's name.

Another bill, listed as AB 85 by Hanna, would require that the buyer be provided with a written list of all encumbrances and would make it a misdemeanor to sell property for an amount in excess of the encumbrances.

Governor Brown opened the current session of the California legislature to consideration of a bill to provide that bonds required in the licensing of automobile dealers shall not protect the monetary interest of a financing agency which has loaned money to the licensee.

The measure was recommended for legislative consideration by Assemblyman Thomas J. MacBride of Sacramento County, who told Brown that a majority of small new and used car dealers would not be able to renew their dealers' licenses for 1961 unless the law is amended because they will not be able to obtain the necessary bond.

MacBride said financing institutions have interpreted present provisions of the law in a manner to permit protection of their loans to dealers. As a result, he said, insurance underwriters are recommending a 100 per cent increase in premiums.

DELAWARE: Real Estate brokers, mortgage bankers, and attorneys

expressed unanimous belief that the average person may find it extremely difficult to purchase a home in Delaware if the state legislature fails to enact a bill listed as HB-526.

They said Delaware's appeal as an area for investment of mortgage money by out-of-state insurance companies and banks will diminish sharply unless the proposed legislation is enacted into law.

The bill, sponsored by Rep. Charles C. King of Smyrna, defines a "cloudy" area of the Delaware code relating to mortgage money and interest charges under FHA and VA loans.

Delaware is one of 11 states where legislation to clarify local law has been or will be introduced. Main objective of the bill is to eliminate "technical" questions that could prompt out-of-state investors to withhold future mortgage funds.

The proposal will have absolutely no effect, up or down, in present home-buying costs, according to home builders, attorneys, mortgage bankers and real estate agents. One banker said it "adds nothing and subtracts nothing."

State Banking Commissioner Randolph Hughes called the proposed legislation "something that should have been done a long time ago."

He said the measure simply would legalize making of charges in FHA or VA loans. The fees are part of federal law governing such loans and have been made in Delaware for years. Hughes described the bill as "enabling" legislation for federal law that is coming a few years late.

IDAHO: A unanimous opinion handed down by the Idaho Supreme Court declared invalid a 1957 state law requiring state-chartered savings and loan associations to obtain savings account insurance from a federal corporation, but exempting such associations if in operation more than 15 years.

The high court agreed with Third District Court which held earlier that the 15-year provision was "arbitrary, unreasonable and discriminatory."

The Supreme Court, however, reversed the lower court on the remainder of the law, ruling that the entire statute was unconstitutional because it gave authority of the Idaho legislature to "another government or agency."

The ruling, written by Justice Henry McQuade, said the 1957 statute was illegal because it violated a constitutional ban on any legislation which attempted to incorporate into Idaho law federal regulations which might be enacted in the future.

"An agreement to be bound by future amendments to the (U.S.) National Housing Act and future rules and regulations of the (Federal Home Loan Bank) board is exacted as a condition to granting the insurance, and also to continuing it in force."

Savings and loan associations, the court said, "can neither obtain

insurance nor continue it in force without being compelled to abide by the unconstitutional provisions of the Idaho act."

KENTUCKY: Governor Combs permitted to become Kentucky law without his signature a bill to increase from $300 to $800 the ceiling on small loans. The measure also reduces the interest rate allowed for larger loans.

MARYLAND: On the grounds it would discriminate against the innocent and fail to curb irresponsible operators, Governor Tawes vetoed a bill to provide limited controls of savings and loan associations.

Although objecting that the bill might lull the public into the belief that "the industry is being properly regulated and controlled," the governor subscribed to the position that there must be full control of the savings and loan business. He said he would appoint an executive commission to work with the committee already assigned by the State Legislative Council with the goal of presenting "appropriate legislation" next year.

Tawes said he had received many complaints from other states of false advertising out of Maryland about savings and loan benefits and guarantees. Much of that advertising, the governor said, has "led individuals to believe that these Maryland associations are insured either by the federal government or by an approved state agency, when, in fact, this is often untrue.

"Naturally, this type of advertising is undesirable and should be controlled. However, this legislation contains no remedy for curbing such advertising."

MASSACHUSETTS: A bill defeated by the Massachusetts Senate would have prohibited automobile dealers selling cars on time from also selling insurance on such cars.

MISSISSIPPI: Conflicting views on whether direct lending by small loan agencies would cost borrowers more or less than brokerage lending now permitted were expressed at a hearing conducted in the Mississippi Senate chamber.

The hearing was on a measure sponsored by Senator Dennis Baker of Batesville to permit direct lending in an effort to secure lower rates for borrowers.

Speaking for the bill under sponsorship of the National Consumer Finance Association, John Gregg, Jackson attorney, said the only issue was "whether we want to allow people the freedom of choice. Direct lending will eliminate the charges and cost the borrower less."

Mississippi now permits lending through brokers, who do not lend their own money but secure it from the lender for the borrower.

"This bill is in no wise compulsory," Gregg said. "People can elect

to either borrow from a lender direct or from a broker. We are the only state which has the compulsory brokerage system."

Opposing the bill on behalf of the Mississippi Consumers Finance Association, J. Will Young, also a Jackson attorney, said the proposed legislation would put brokers out of business because lenders would stop making money available to them. He said lenders wanted a 20 per cent return which would be available with an 8 per cent interest and other charges.

Gregg said the bill states that a maximum interest of 8 per cent is permissible but that it would permit sounder borrowing at lower rates. He contended that the public would benefit from the bill and that the only opposition was coming from brokers.

NEW JERSEY: Four consumer protection bills, featuring finance charge limits on installment contracts for cars, general merchandise and home improvements, were introduced in the New Jersey Senate amid predictions of favorable action before the legislature recesses for the summer.

Two of the bills are more stringent substitutes for measures introduced earlier. One, Senate Bill No. 200, replaces Senate Bill No. 59. It would set maximum charges of $7 per $100 per year on new car time sales, $10 on cars up to two years old and $13 on cars over two years old, and $10 per $100 per year on general merchandise.

Another bill, listed as Senate Bill No. 201, replaces Senate Bill No. 169. It would set maximum finance charges on home improvement installment contracts of $7 per $100 per year and provide for state licensing of contracts and finance agencies.

A third bill would require clear statements of finance charges and their percentage of the credit extended "expressed in terms of simple annual interest" in all retail and home repair installment contracts.

The fourth proposal would empower the state attorney general to crack down on fraudulent selling and advertising practices.

NEW YORK: An insurance premium financing regulatory bill was given final passage by the New York State legislature and sent to the governor for signature.

The measure, sponsored by Senator Walter Van Wiggeren of Montgomery County, provides a rate of $7 per $100 per annum with a minimum financing charge of $10. It also provides that those in the business of financing premiums will be known as premium finance agencies and be licensed and supervised by the State Banking Department.

Under the bill, insurance agents and brokers will be able to finance premiums themselves for their insured up to a total outstanding of $15,000 at any one time by obtaining a license from the banking department for an annual fee of $20.

Insurance agents also will be able to finance premiums in any amount they desire without being licensed under the bill provided the rates charged are no greater than those permitted by existing law (6 per cent simple interest).

The measure prescribes the form and content of the finance agreement in order to give "full disclosure and protection to the public, prevent deception, and eliminate unfair clauses." Refunds of unearned financing charges are required when the insured prepays a loan. The bill prohibits rebates from a premium finance agency to an agent or broker.

In another development, Governor Rockefeller signed into law a controversial state legislative bill to allow New York City banks to expand into Nassau and Westchester counties; authorize the formation of holding companies to operate banks throughout the state; and allow existing banks to open additional branches.

NORTH CAROLINA: Possibility of separate premium ratings for insurance companies which write accident and health policies on small loans drew objections from one firm at a hearing conducted by North Carolina State Insurance Commissioner Charles F. Gold.

The hearing had been called to determine whether so-called "captive" insurance companies—those owned by finance companies—should be rated separately from independent companies writing policies on small loans. No action was immediately taken on the question.

Thomas D. Cooper Sr., an attorney representing Charter National Life Insurance Co., said the commissioner's idea would be illegal if put into practice.

Gold, who rejected Cooper's request that the proposal not even be considered at the hearing, reviewed loss experience by insurance companies writing such policies. Figures presented by his department showed that 19 companies wrote $10,814,500 worth of small loan insurance during an eight-month period, during which it paid out $3,501,291 in losses.

W. W. Taylor Jr., an attorney representing the North Carolina Credit Accident and Health Rating Bureau, said the loss ratio of 11 companies has gone up 13 per cent since Gold cut accident and health rates on small loans in December.

Gold at that time cut the rate from $2 to $1.75 for each $5 of monthly benefits. The commissioner conceded that the loss ratio would be greater since the cut.

Taylor and others contended that the loss ratio should include the expenses of insurance companies. The department's figures did not include such statistics.

The small loan industry in North Carolina has been under study by both the State Insurance and State Banking departments since the

former State Attorney General Malcolm Seawell branded the operations of a Roxboro loan firm a "damned outrage."

Gold declared at the hearing that "there's been too much insurance sold for loans for a long period of time." Under present rates, a person borrowing $100 for 12 months pays $35 for accident and health insurance.

The commissioner said some insurance firms are getting policyholders to pay off loans when claims are made on the policies. In some cases, he added, the borrower then makes another loan and buys more insurance within a short period. "That's not the purpose of this business," Gold said, referring to the insurance aspect of loans.

Some companies, he continued, are allowing their insurance agents to have too much control of the mechanics of policy-writing through the use of various types of claims forms and tear-out policy forms. The commissioner said he was considering the issuance of a cease and desist order to stop such practices.

Taylor said insurance sold with loans "affords protection for many thousands of people in this state who could not normally afford accident and health insurance."

He said from the middle of December through February accident and health companies had experienced a 49 per cent loss ratio. The ratio was 56.49 per cent for December and January and 77.54 per cent for February, according to Taylor, who attributed the rising loss to the rate cut authorized by the commissioner. Only a portion, he added, could have been caused by flu and virus that swept North Carolina.

SOUTH CAROLINA: A measure providing for the creation of a nine-member committee to investigate consumer financing in the state was approved by the South Carolina House and sent to the State Senate.

TENNESSEE: A decision handed down by the Tennessee Supreme Court held that state usury laws are not being violated on FHA loans.

The high court's decision came in a challenging case brought in Memphis by Silver Homes, Inc., against Marx and Bensdorf, Inc. Silver Homes sought a Chancery Court decision requiring Marx and Bensdorf to issue the mortgage loan on a home.

Marx and Bensdorf refused the loan because the FHA-approved interest rate of 5¾ per cent plus the ½ per cent FHA mortgage insurance fee exceeded the 6 per cent limit under the Tennessee usury law.

Chancellor Charles A. Rond ruled in favor of the applicant. His decision was upheld by both the State Court of Appeals and the Supreme Court.

The high tribunal held that the ½ per cent insurance charge is not interest inasmuch as it was an expense "incident to making the loan and furnishing satisfactory security for its repayment."

The court also said that the insurance charge is paid to the FHA and "cannot be considered compensation to the lender for the use of money loaned."

The suit was filed after state officials expressed an opinion that the FHA maximum charges violated Tennessee law. Loan firm officials and bankers said out-of-state firms were withholding money for home loans in Tennessee until the matter could be determined by the courts.

VERMONT: Small loan firms lent $11,067,237 to 28,089 Vermont residents during 1959, according to the annual report of the State Department of Banking and Insurance.

It further disclosed that 26 small loan companies collected $2,552,545 in interest or charges from borrowers; the average monthly rate of interest charged was 2.029 per cent; and the average size of each loan was $394.

There were 10,801 loans of $500 or more, and 3,222 loans reported between $400 and $500. The remainder of the loans were for less than $400.

Most of these loans, the report said, were for chattel mortgages on household goods, with 19,266 loans in that category. Another 2,702 loans were made on automobiles, while 4,757 loans were made on unsecured notes.

The report listed the total assets of the loan companies at $7,117,053. Only one new loan firm was licensed by the department during the year.

TEXAS SUIT INVOLVES QUESTION OF BRANCHES ON MILITARY POSTS

It has been reported recently that a Federal District Court in Texas is to consider whether the numerous banking installations on federal military posts in Texas are limited facilities legally performing specific federal functions or whether they are branches and as such are expressly forbidden by Texas law. The State through its Attorney General takes the position that under Texas statutes accepting deposits and cashing checks may be done only in "the main banking house" and therefore seeks an injunction against two national banks to prohibit them from continuing their operations on military posts.

TRUST AND ESTATE TAX DECISIONS

Digest of current decisions pertaining to the law of taxes on trusts, estates and gifts.

Only One Legacy Tax on Exercise of General Testamentary Power

Curtis, trustee v. Commissioner, Massachusetts Supreme Judical Court December 17, 1959

Decedent exercised a general testamentary power in favor of her estate. By her Will, she left her residuary estate in trust. *Held*: The residuary trust received the appointive property from the donor of the power, and not from the decedent. Only one Massachusetts legacy tax is payable.

Assessment of Income Tax Deficiency Stops Accrual of Interest on Estate Tax Overpayment

Robert J. Felixson, Executor v. United States of America, United States District Court, Southern District California, January 21, 1960

An audit revealed that decedent's executor had made an overpayment of estate taxes. Subsequently, an assessment of additional income tax with interest was made against the estate. *Held*: The estate was entitled to interest on the estate tax overpayment only until the date on which the income tax deficiency was assessed, although the estate was liable for interest on the income tax deficiency until the time when the estate tax overpayment was actually credited against the income tax deficiency.

Full Credit Allowable for Death Taxes Imposed by Two States

Revenue Ruling 60-88, I.R.B. 1960-10, p. 20

The Internal Revenue Service has recently advised as to the proper credit allowable to an estate for state death taxes where each of two states claimed jurisdiction to tax on the basis of the decedent's domicile. It had been proposed that a compromise be entered into by the executor whereby the total death taxes to be paid to the two states would not exceed the maximum allowable credit to the estate under the Internal Revenue Code. *Held*: A credit will be allowed for the amount paid to each state, up to the maximum total credit allowable, even though the compromise agreement may designate only one of the states as the domicile of the decedent.

Estate of Donee of Power of Appointment Liable for Missouri Inheritance Tax

M. T. Hall, Executrix v. Carpenter, Director of Revenue, Supreme Court of Missouri, Division One, February 8, 1960

Decedent was the donee of a power of appointment over a share of the principal and income of a trust. She died without exercising the power. The relevant Missouri statute provides in part that the property so passing shall be taxed as though "the property to which said appointment relates belonged absolutely to the donee of such power and had been bequeathed or devised by the donor by will." The executrix urged that the latter provision required the property to be taxed in the estate of the donor of the power. *Held*: The property is taxable in the estate of the donee. The provision as to the donor of the power was interpreted to mean "had been bequeathed or devised by the donor [to the donee] by will."

Corpus of Trust For Maintenance and Support of Wife Includible in Gross Estate

Estate of W. H. Lee v. Commissioner of Internal Revenue, United States Tax Court, March 25, 1960

Decedent established an irrevocable trust retaining no powers to amend or to control the activities of the trustee. The trust income was to be paid to his wife during her lifetime, and then to his adult son, in each case for the "maintenance and support" of the income beneficiary. Upon his death, the Commissioner included the full value of the trust corpus in his gross estate, on the ground that he had retained possession and enjoyment of the trust income. *Held*: The trust income could only be used to discharge the decedent's obligation of support, and the corpus was thus taxable in his estate. Further, in view of decedent's wealth, the trust income was not in excess of the support which would legally have been required of him.

United States Currency is Intangible Property

H. R. Thomas, Executor v. Commonwealth of Virginia, Supreme Court of Appeals of Virginia, November 27, 1959

Decedent died a domiciliary of Virginia. At the time of his death, he owned $263,100 in United States currency located in a safe deposit box in Washington, D. C. *Held*: The currency is intangible personal property, properly subject to inheritance tax by the jurisdiction in which the decedent was domiciled at the time of his death.

TRUST DECISIONS

Digest of current decisions pertaining to the law of trusts, wills, estates, descent, distribution and corporate fiduciaries

Trustees' Discretion to Allocate Stock Dividends is Limited

Estate of Galopin, New York Surrogate's Court, Suffolk County, 142 NYLJ 13, December 30, 1959

The primary life beneficiary of a testamentary trust objected to an intermediate account on the ground that certain stock dividends had been allocated to principal. The trustees had the power to allocate stock dividends "in their discretion." *Held*: The discretionary power must be exercised "within reasonable bounds", and the trustees were required to allocate to income those stock dividends which were "obviously in the nature of income".

Rights of Unborn Children may be Determined Although no Member of Class is in Being

Peoples National Bank v. Barlow, South Carolina Supreme Court, January 14, 1960

The testatrix bequeathed property in trust for the benefit of certain minors. Children who were born of designated persons were to take with the other beneficiaries when they reached majority. No children had been born of the designated persons at the time of death of the testatrix. *Held*: Only children who were born between the time of execution of the will and the death of the testatrix were intended to share in the distribution. Despite the absence of a permissive statute, the rights of the class of unborn children were properly represented by a guardian ad litem although no member of that class was in being.

Jury Decides Whether Unfastened Pages Constitute Will

In Re Roberts, North Carolina Supreme Court, January 29, 1960

A document comprised of four unfastened sheets of paper in the testator's handwriting, folded together and allegedly constituting the testator's will, was found in his safe. The papers had holes in them as if they had been formerly stapled together. One of the attesting witnesses testified that the document which he had signed was composed of several sheets, "as many as three or four". *Held*: It was proper to allow the jury to find, on the basis of the evidence, that the document constituted the testator's will.

Decedent's Estate Entitled to Trust Distributions Not Made Because of Unforeseen Delay

Thorndike v. Dexter, Mssachusetts Supreme Judicial Court, February 11, 1960

A will created a residuary trust for the benefit of his daughters and their issue. It directed that the net income be paid "quarterly, or oftener if convenient, to my daughters living at the time of such payment". A tort claim was filed against the estate, and, as a result, no distributions were made for some time from the trust. Decedent, a daughter, died before any payments were made, and her executors claimed the accrued income to the date of her death. *Held*: The testator intended that quarterly payments be made beginning with his death. Since the tort claim was an extraordinary circumstance, the deceased daughter's representatives were entitled to the payments which should have been made while she was alive, but not to the accrual up to the date of her death.

Attorney Named in Will Not Entitled to Fee for Services After Discharge by Executrix

Hoxsey v. Fullerton, New Mexico Supreme Court, February 8, 1960

The will named a particular attorney to handle the probate proceedings for the testator's estate, but the executrix, the decedent's widow, discharged the named attorney. Five months later the trial court entered an order finally discharging the named attorney. The latter made a claim for services rendered up to the time of the entry of the order which removed him. *Held*: The executrix had the right to discharge the attorney named in the will, and he was thus entitled only to compensation for services rendered up to the time he was notified of his discharge as attorney.

No Ademption Where Subject of Bequest Demolished at Time of Testator's Death

In Re Buda, New York Surrogate's Court, Kings County, 143 NYLJ 16, January 27, 1960

Decedent was killed in an accident in which the automobile in which he was riding was completely demolished. He had bequeathed the automobile specifically to his daughters. The automobile was insured under a policy which gave the insurance company the right either to pay for the loss or to repair the vehicle, and the company elected to pay the loss. *Held*: The insurance proceeds are to be paid to the daughters. The general rule, that a specific bequest will fail if the subject of it ceased to exist so as not to be part of the testator's property at his death, should not be applied where the destruction is simultaneous with his death.

INVESTMENT AND FINANCE

Edited by OSCAR LASDON

Caution on Consumer Credit

C. A. Sienkiewicz, president of the Central-Penn National Bank of Philadelphia, has voiced a number of reservations about new forms of consumer credit, the so-called "charge-credit" and "revolving credit" plans. Under these arrangements, banks establish lines of credit in specified amounts for individual borrowers; a customer then borrows by simply writing out his check, and the bank charges interest monthly on the outstanding balance. Charge-account banking was more fully described in these columns in the February issue.

Although the charge-credit borrower is expected to repay his loan in installments over a period of time, this may not turn out to be the case in actual practice. What is disturbing is the fact that the loan may be maintained at or near the ceiling limit—thus imparting characteristics of a perpetual loan scheme.

"I cannot help wondering," remarks Mr. Sienkiewicz, "if those bankers who are so vigorously pushing this new plan have carefully considered all aspects of it. Is it sound policy to encourage individuals to remain continuously in debt? If so, are thrift and the practice of living within one's means no longer virtues?" To say the least, the Philadelphia banker is hardly complacent about encouraging a type of lending arrangement that will encourage excessive borrowing and spending.

Mr. Sienkiewicz takes issue with those bankers who contend that there is little or no difference between the revolving credit plan and the practice of renewal of personal and even other consumer loans. Personal loans always bear a definite maturity date and are expected to be repaid at such time; and although the need for additional funds sometimes becomes necessary, there is, on such occasion, a personal review and discussion of the borrower's circumstances. The renewal that follows has a terminal date and embodies provisions which require regular reductions of the loan. Also, the lender is entitled to (and has) a fair knowledge of how the loan is to be used.

On the other hand, the revolving credit plan does not provide for a terminal date of repayment, even though periodic reductions are expected. Nor does the bank have knowledge of the specific purpose of the loan.

At first sight, individual revolving credit seems to promise a good source of additional bank earnings. However, experience has as yet been limited, and it is entirely possible that earnings may be slow to develop or prove disappointing. It will take time to discover whether burdensome advertising costs, the expense of screening applicants and a high rate of rejections, and expensive administration will materialize and dispel the apparent at-

tractiveness of this type of earning asset.

Other factors to be considered include the cost of servicing check credit, which may be higher than anticipated. Also, loss experience may be heavy in the event of a business downturn, with its attendant unemployment and loss of personal income. According to the Central-Penn National Bank president, the danger of such losses is particularly great because the lending institution is not normally aware of the uses to which the loan is put.

Higher costs and greater losses necessarily spell an inadequate return for the bank. In such event, asks Mr. Sienkiewicz, will political and popular pressures permit an increase in interest rates to a level which allow adequate earnings?

Mr. Sienkiewicz, who is also chairman of the Committee for Economic Growth Without Inflation, submits a number of precepts which he regards as applicable to consumer credit policies and practices.

1—Any form of lending which does not permit personal knowledge of the borrower and satisfaction as to judicious use of the loan proceeds is suspect. The good credit analyst should be alerted by the fact that the borrower is unwilling to disclose the purpose of the loan. The banker's job encompasses advice as to the use of borrowed funds as well as providing them, and personal contact is regarded as essential.

2—Appraising individual credit risks is most difficult. This is due to the lack of dependable information as to the borrower's income, his indebtedness, and the relationship of these two important factors. Under the spur of optimism, families frequently borrow from more than one bank and finance company, owe money to store and fuel dealers, and are in arrears on mortgages as well. Absent is any satisfactory credit clearance to check on such overextensions and, because of this, the lending officer is without the tools to make a sound decision. Essential is the establishment of a more comprehensive system of credit information by banks, merchants and others dealing in consumer credit. This would tend to prevent credit abuses and minimize losses.

3—Extravagant advertising should be avoided. The nonbank public finds it easy to misinterpret advertising aimed at making borrowing more convenient for creditworthy borrowers; often, such advertising is taken as an open invitation for all to come in and borrow. Thrift and repayment of debt should be emphasized, and any advertising which may be misinterpreted as encouraging the maintenance of an excessive and perpetually indebted position should be avoided. Borrowing is not a permanent substitute for saving, but is only a device to be used in case of need.

4—Costs and returns involved in the making of different types of loans should be compared. Net returns on newer forms of consumer credit may prove much lower than expected, or may result in losses in the longer run.

5—Competition is important, but it should not engender a relaxation of credit standards and practices. Such competition weakens the banking system. Competition in banking should take the form of

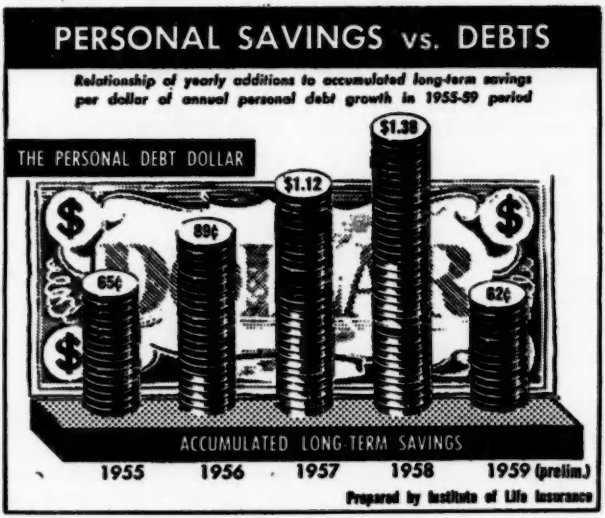
offering better service at lower cost, and this serves to strengthen the banking system.

Mr. Sienkiewicz made these observations at a recent meeting of the National Installment Credit Conference, which was sponsored by the ABA Installment Credit Commission.

Personal Debt

Every dollar of net increase in personal borrowing last year was offset by only 62 cents of additional long-term savings. According to the Institute of Life Insurance, this relationship represented an abrupt about-face of 1958 performance. In 1958, each dollar of personal debt increase was offset by $1.38 in personal savings. The 1959 ratio was the most unfavorable since 1950, which year reflected the carryover of wartime consumer goods shortages plus the onset of the Korean conflict.

The Institute regards the 50 per cent jump in personal debt expansion last year with serious concern. The rising prevalence of "Buy Now, Pay Later" plans has swelled the record debts already established by the more traditional forms of personal borrowing. The Institute is also considerably disturbed



by the reduced growth of savings, particularly so with respect to the vital area of capital formation.

Interest Rates

"The Causes and Effects of Higher Interest Rates" are discussed by Professors Jules Bogen and Paul S. Nadler in a banking research study, issued under the auspices of the Graduate School of Business Administration of New York University.

Though the survey is too comprehensive to be covered here in detail, some of the salient findings are outlined below.

1—Interest rates on loans to small business have risen less than on large business loans. Effect of a credit stringency on small business is diminished by the greatly increased use of trade credit by smaller concerns, wider resort to factoring and accounts receivable financing, and the trend towards leasing of equipment.

2—Interest costs are a very small element of total business costs. The effect of higher interest rates on business costs and selling prices is relatively negligible. It is negligible as compared with the upward pull on prices that would result from large-scale bank credit expansion designed to keep interest rates down.

3—Business borrowers are little affected by increased interest rates on their borrowing. The return to business on its capital funds averages much higher than the interest rates paid; also, interest expense is deductible from taxable income. And where loans are not available in the volume sought, a number of alternative money-raising methods are available.

4—Effect of higher interest rates on mortgage borrowers has been offset by increased ratios of loan to property values and lengthening of mortgage maturities, as well as by the pronounced rise in personal incomes.

Lessened availability of funds has affected mortgage borrowers more than other classes of borrowers; this is due to the huge amounts of money mortgage borrowers require, and their dependence on four classes of savings institutions for the bulk of the funds they obtain. Mortgage borrowers are not presently able to attract funds in volume directly from individual investors, as do those classes of borrowers that sell bond issues.

5—Consumer borrowing is relatively little affected by higher interest rates and reduced availability of loanable funds. This is because, at all times, the rates charged are relatively high and standardized—including a large element of payment for service as well as interest on the money borrowed.

6—A growing economy requires a gradual expansion in the money supply. However, the increase in demand deposits should be limited in times of prosperity. The velocity of turnover of bank deposits increases when business is good; also, during recession, bank deposits usually undergo rapid expansion due to Treasury deficit financing and easy money action taken by the Federal Reserve System.

7—Legal interest rate ceilings make credit unavailable to affected borrowers when market rates of interest rise above the fixed maximum rates—except where expedients are available for evading the ceilings.

8—Stability of the price level contributes to a stability of interest rates and greater availability of credit. This results from limiting demands for funds and increasing the supply through encouraging the flow of savings into thrift institutions and bonds.

9—The prime cause for the rise in interest rates since 1946 has been a huge demand for funds. Since the end of World War II, private and public debt has increased more than in the entire preceding history of the United States.

10—Complaints against higher rates are, in many instances, actually directed at the unavailability of credit to some borrowers—because total demands for funds outrun the available supply.

ABA Cost Manual

A new manual has just been completed by the Committee on Savings Management and Operations of the Savings and Mortgage Division of the American Bankers Association. The booklet outlines a 9-step method for determining the costs of various operations in the savings and mortgage field. It can be used by both commercial and savings banks.

The analysis is nontechnical in nature and the procedure can be followed by any bank officer without prior training in cost accounting. Chairman of the committee is Leonard P. Chamberlain, vice president of the Provident Institution for Savings of Boston, who declares that following of instructions outlined in the manual makes it possible to obtain an accurate cost analysis "in any bank regardless of past experience."

Purpose of the new booklet and sample forms are:

1—To segregate the income and expenses applicable to savings account operations.

2—To determine the gross yields, total costs, and net yields from the earning assets in which savings funds are invested.

3—To determine mortgage loan costs.

4—To outline a procedure for computing transaction costs of various types.

5—To determine net earnings on savings deposits.

The simplified cost analysis procedure is divided into 9 steps providing for the allocation of expenses and costs to various phases of savings operations. After costs have been determined, a second section describes a method for determining profit and loss on savings and mortgage lending in commercial banks and a method applying to mutual savings banks.

Copies are being mailed to all ABA member banks.

Odds and Ends

"Understanding the New York Stock Exchange" and "Marketing Methods for Your Block of Stock" are available from the New York Stock Exchange, 11 Wall Street, New York City.

"Pension Funds and Economic Freedom," by Robert Tilove, is available from The Fund for the Republic, 60 E. 42 Street, New York City, 17.

BOOKS FOR BANKERS

FUNDAMENTALS OF MUNICIPAL BONDS. Edited by George L. Calvert. Investment Bankers Association of America. Washington, D.C. 1959. Pp. 149. $2.00. In response to a widespread demand for a simple exposition of municipal bonds, the IBA has prepared an invaluable explanation of these obligations and the procedures involved in their issuance, marketing, underwriting and investing. It is the type of concise manual that is most useful to investment officers who need quick, informative answers in specific areas.

INVESTING IN AMERICAN INDUSTRIES. Edited by Lester V. Plum. Harper & Brothers. New York. Pp. 404. $6.95. Financial specialists in ten major industries have combined their efforts in this single volume to acquaint the general investor with some of the finer points of security analysis.

The areas covered are non-ferrous metals, steel, business machines and electronic data processing, chemicals, paper, electric utilities, railroads, petroleum, aircraft, and insurance. Also included are a helpful glossary and a bibliography of sources of trade information.

The volume is both informative and well-written, and merits a prominent place in the analyst's financial library.

STUDIES IN COMPANY FINANCE. Edited by Brian Tew and R.F. Henderson. Cambridge University Press. New York. Pp. 301. $6.50 This volume presents the first analytical summary of the financial position of those British industrial companies whose shares are quoted on the London Stock Exchange. It covers, for the five-year period 1949-53, the 2,549 companies which are responsible for approximately half the total output of British manufacturing industry.

Sponsored by the National Institute of Economic & Social Research of Great Britain, a series of studies examines the companies' growth, dividend policy, and their access to and use of the commercial and investment banking markets.

This symposium on the economic analysis and interpretation of British company accounts, which covers industry analysis as well, is a monumental landmark in economic-financial literature.